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# The Federal Tax Law of Hospitals: Basic Principles and Current Developments

*Bruce R. Hopkins*  
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## I. INTRODUCTION

"[T]he historical distinction between for-profit and nonprofit hospitals has eroded." With those few words, their author encapsulated the dilemma facing the contemporary nonprofit hospital under American legal principles. These ten words were not written by some academician preparing a scholarly analysis destined only to gather dust on library shelves. Rather, their source was the Supreme Court of the State of Utah, writing in 1985.<sup>1</sup> Thus its words, and the analysis underlying them, are now part of American hospital law.<sup>2</sup> In recent years, the nature and operations of nonprofit hospitals have changed dramatically in response to financial constraints and increased demands for service imposed upon all health care providers. In order to meet these demands, nonprofit hospitals have sought new sources of revenue and have affiliated with other nonprofit organizations, for-profit organizations, and profit-motivated investors.

Corresponding with these changes in the activities and structure

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1. *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 (Utah 1985).

2. Although this article is concerned exclusively with federal tax as opposed to state tax issues, the *Intermountain Health Care* case is relevant to this article insofar as it represents an example of a recent trend to question whether nonprofit hospitals deserve some of the tax privileges traditionally accorded to them. Should the view of the majority of the Utah Supreme Court be widely accepted by other state courts, the federal tax exemption for nonprofit hospitals could be affected. See *infra* notes 23-89 and 212-19 and accompanying text.

of many modern nonprofit hospitals have been developments in the federal tax laws regarding the tax consequences of these activities and affiliations. As illustrated by the conclusions of the jurists in Utah, this combination of rapidly developing tax law and dramatic change in hospital structure, affiliations, and operations presents the potential for adverse affects on the privileged tax status presently enjoyed by nonprofit health-care providers.

In the Utah Supreme Court opinion, the court held that a typical nonprofit hospital was not a "charitable" entity for tax exemption purposes because it operated no differently than a for-profit hospital.<sup>3</sup> If the decision is relied upon by other courts, it could represent the beginning of a line of cases depriving nonprofit hospitals of their privileged charitable status, whether for federal or state tax, postal law, or other purposes.

This case concerned a state property tax exemption for a nonprofit, federally tax-exempt charitable hospital that owned or leased twenty-one hospitals and several subsidiaries, at least one of which was a for-profit organization. Most of the hospital's revenue was derived from patient charges (either directly or from third-party payors); some receipts were in the form of contributions.

The issue before the Utah Supreme Court was whether this hospital qualified as a charitable organization for purposes of the state's property tax exemption. Finding against the hospital, the court concluded that the traditional assumptions about the charitable nature of nonprofit hospitals "bear little relationship to the economics of the medical-industrial complex of the 1980's."<sup>4</sup> In the court's view, the primary care services of both nonprofit and for-profit hospitals are largely the same, as are their rates and operations.

Modern nonprofit hospitals, the court concluded, are "market institutions,"<sup>5</sup> financed primarily out of payments from patients,

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3. Frequently, throughout this analysis, nonprofit and other entities described in the federal tax law defining the rudiments of tax exemption, I.R.C. § 501(c)(3), and of deductible charitable giving, I.R.C. § 170(c)(2) (income tax charitable deduction); I.R.C. § 2055(a)(2) (estate tax charitable deduction); and I.R.C. § 2522(a)(2) (gift tax charitable deduction) are referred to as "charitable" organizations, in an effort to minimize the appearance of repetitious Internal Revenue Code citations and in reflection of the teachings of the United States Supreme Court in *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983) (holding that all entities described in these four federal tax provisions must adhere to certain common law standards of charity).

4. *Intermountain Health Care*, 709 P.2d at 270.

5. *Id.* (quoting Starr, *The Social Transformation of American Medicine* at 146 (1982)).

either directly or through third-party payors. This fact was critical to the court's decision. The court wrote that "[n]onprofit hospitals were traditionally treated as tax-exempt charitable institutions because, until late in the 19th century, they were true charities providing custodial care for those who were both sick and poor."<sup>6</sup> The income of these traditional charitable hospitals for the poor, noted the court, was derived largely or entirely from gifts.

The court described two types of nonprofit hospitals as being representative of this new type of "market institution." In the "physicians cooperative" model, hospitals "operate primarily for the benefit of the participating physicians."<sup>7</sup> In this regard, the court used the term "exploitation hypothesis" to describe its finding that the physician "income maximizing" system is "hidden behind the nonprofit facade of the hospital."<sup>8</sup> The second type of nonprofit hospital conceptualized by the court, the one for which the court reserved its harshest criticism, is the "polycorporate enterprise"<sup>9</sup> model. These are "large groups of medical enterprises, containing both for-profit and nonprofit corporate entities."<sup>10</sup> Neither of these models, the court concluded, bears any real resemblance to the traditional charitable hospital for the poor, nor are they distinguishable from modern for-profit hospital organizations.

The Utah Supreme Court, therefore, does not accept the rationale found in federal tax law, that the "promotion of health," in and of itself, is a "charitable" end.<sup>11</sup> Wrote the court: the "meeting of a public need by a provision of services cannot be the sole distinguishing characteristic that leads to an automatic property tax exemption."<sup>12</sup> Were the provision of such services the sole basis for giving an organization a tax exemption, the court reasoned, for-profit as well as nonprofit hospitals should be granted such an exemption. Thus, the court found that absent a distinction between

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6. *Intermountain Health Care*, 709 P.2d at 270.

7. *Id.* at 271. See also Pauley & Redisch, *The Not-For-Profit Hospital as a Physician's Co-operative*, 63 AM. ECON. REV. 87, 88-89 (1973).

8. *Intermountain Health Care*, 709 P.2d at 271. See also Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1436-37 (1980).

9. *Intermountain Health Care*, 709 P.2d at 271.

10. *Id.*

11. There is no provision in the Internal Revenue Code or in the accompanying tax regulations that declares the promotion of health to be a "charitable" purpose. Rather, "[t]he term 'charitable' is used in section 501(c)(3) in its generally accepted legal sense . . . ." Treas. Reg. § 1.501(c)(3)-1(d)(2).

12. *Intermountain Health Care*, 709 P.2d at 276.

for-profit hospitals' and nonprofit hospitals' activities, neither category of hospital can qualify as a charitable organization for the purpose of determining eligibility for the Utah property tax exemption.<sup>13</sup>

The dissenting opinion stated that the majority's conclusions are "without precedent either in Utah or elsewhere in the United States."<sup>14</sup> Certainly, the court's conclusion that nonprofit hospitals are not operated for a charitable purpose is a flat contradiction of the following passage from a well-established revenue ruling issued by the Internal Revenue Service:<sup>15</sup>

In the general law of charity, the promotion of health care is considered to be a charitable purpose. *Restatement (Second), Trusts*, sec. 368 and sec. 372; *IV Scott on Trusts*, (3rd ed. 1967), sec. 368 and sec. 372. A nonprofit organization whose purpose and activity are providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose.<sup>16</sup>

However, academics and others have for some time been questioning the nonprofit tax-exempt status of hospitals and other nonprofit organizations.<sup>17</sup>

The dissent found that the basic rationale of the majority opinion was "that no essential difference exists between for-profit and nonprofit hospitals."<sup>18</sup> Thus, the dissent concluded, "the Court's reasoning sweeps in every nonprofit hospital that receives revenues from patients or third-party payors."<sup>19</sup>

To the extent that this criticism is a correct interpretation of the scope of the majority opinion, the majority diverges from recent developments in federal tax law as well as from the general law of charities relied upon in the interpretation of the federal tax law.<sup>20</sup> The receipt by a hospital of a payment from third-party payors, such as Medicare and Medicaid, or from patients, is generally a positive rather than a negative factor with respect to any claim of

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13. *Id.* at 276-77.

14. *Id.* at 279 (Stewart, J., dissenting).

15. Hereinafter the Internal Revenue Service will be referred to as the "IRS" or the "Service."

16. Rev. Rul. 69-545, 1969-2 C.B. 117.

17. See, e.g., U.S. Small Business Administration, Office of Advocacy, *Unfair Competition by Nonprofit Organizations With Small Business: An Issue for the 1980's*, (Nov. 1983); Clark, *supra* note 8.

18. *Intermountain Health Care*, 709 P.2d at 279 (Stewart, J., dissenting).

19. *Id.* at 279-80 (Stewart, J., dissenting).

20. See *supra* notes 11 & 16 and accompanying text.

tax-exempt or other favorable tax status.<sup>21</sup> Thus, the majority's conclusions are indeed somewhat troublesome, and cannot be explained away solely by reference to any unique aspect of Utah law.

Irrespective of the novelty of the Utah Supreme Court's decision, the fact remains that nonprofit hospitals and other tax-exempt health care organizations are increasingly engaged in non-traditional activities, sometimes with non-traditional affiliates. Although the reaction of the taxing authorities and courts to nonprofit hospitals' operations has not been as extreme as that of the Utah Supreme Court, these organizations and their professional advisers must be aware of the limits—both existing and developing—placed upon tax-exempt health-care organizations. This article is intended to serve as an introduction to the fundamentals of federal income tax exemption, and as a summary of recent developments in that body of law, as applied to the modern nonprofit health care and hospital organization's operations, structure, and affiliations.

## II. THE FUNDAMENTALS OF EXEMPTION FROM FEDERAL INCOME TAXATION

### A. *In General*

Many types of organizations are eligible for tax exemption under various provisions of the Internal Revenue Code.<sup>22</sup> In its many subsections, the Code describes a remarkable array of nonprofit organizations.<sup>23</sup> For purposes of this analysis, the most important of

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21. See, e.g., Rev. Rul. 83-153, 1983-2 C.B. 48. In that ruling, the issue was not health care organizations' tax-exempt status, but rather their qualification for the favorable non-private foundation status under the public support tests of I.R.C. §§ 170(b)(1)(A)(vi) and 509(a)(2)(A). For the purpose of these tests, the Service ruled that payments received from third-party payors, such as Medicaid and Medicare, although not outright government support, constituted gross receipts derived from the exercise or performance of exempt functions (as do payments by the patients themselves). With respect to the I.R.C. § 170(b)(1)(A)(vi) public support test, this ruling is detrimental, but it is advantageous with respect to the § 509(a)(2)(A) public support test. For purposes of this analysis, the importance of the ruling is that favorable non-private foundation status is granted to health care organizations not merely in spite of, but in part because of income received from patients and their insurers.

22. Most exemptions are granted under I.R.C. § 501(a), which provides that organizations described in certain other sections of the Code shall be exempt from taxation. The most important of these sections describing exempt organizations is I.R.C. § 501(c).

23. I.R.C. § 501(c) presently has 23 subsections, embracing nonprofit entities such as title-holding corporations, labor organizations, trade and professional associations, social clubs, fraternal organizations, cooperatives, cemetery companies, credit unions, employee benefit funds, and veterans' groups. Other types of tax-exempt organizations are authorized in I.R.C. §§ 501(d)-(f), 521, and 526-28.

these provisions is I.R.C. § 501(c)(3), which grants tax-exempt status to "charitable" organizations.<sup>24</sup>

Although tax-exempt organizations pay no federal income tax, many pay other federal taxes. Most of these other taxes accrue when the tax-exempt organization performs certain activities. For example, a tax-exempt organization that regularly conducts a business not related to its exempt purposes generally will have to pay a tax on the net income derived from the undertaking.<sup>25</sup> Another example of such a tax is the excise tax on acts of self-dealing imposed upon certain tax-exempt organizations known as "private foundations." This tax is levied when the private foundation enters into a transaction with a related, or "disqualified," person.<sup>26</sup> Other taxes accrue to certain tax-exempt organizations by virtue of their less-privileged status. This is true, for example, of the excise tax on the net investment income of most private foundations.<sup>27</sup>

In addition to their exemption from federal income taxation, "charitable" organizations are granted favorable treatment in other ways. Generally, these organizations are eligible to receive tax deductible contributions.<sup>28</sup> They are not required to pay federal unemployment taxes on their employees' wages<sup>29</sup> and are not subject to involuntary bankruptcy proceedings.<sup>30</sup> They also may enjoy preferential mailing rates.<sup>31</sup> Many state and local taxing authorities automatically grant income, sales, and property tax exemptions to organizations having tax-exempt status under federal law.

Exemption from federal income taxation is granted to qualified organizations by law and recognized by the IRS in response to requests containing adequate proof of eligibility for exemption submitted by the organizations.<sup>32</sup> The law does not generally require

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24. I.R.C. § 501(c)(3). *See also supra* note 3.

25. *See infra* notes 120-21 and accompanying text.

26. I.R.C. § 4941(a)(1).

27. I.R.C. § 4940.

28. *See supra* note 3. This privilege is accorded only to organizations described in § 501(c)(3) which are not organized and operated exclusively for the purpose of testing for public safety. I.R.C. § 170(c)(2)(B).

29. I.R.C. § 3306(c)(8).

30. 11 U.S.C. § 303(a) (1980).

31. 39 U.S.C. § 3626 (1980). Domestic Mail Manual, Parts 421 and 622.

32. Such requests generally must be submitted on forms specified by the IRS. *See* Treas. Reg. § 1.501(a)-1(a)(3). For example, most organizations desiring recognition of their tax-exempt status under § 501(c)(3) must timely file a substantially completed Form 1023, Application for Recognition of Exemption. Treas. Reg. § 1.508-1(a)(2)(i). In addition, such organizations must submit any other information that the IRS requests to determine eligibility for exemption. Treas. Reg. § 1.501(a)-1(b)(2)(iv).

organizations to apply for recognition of exemption, although charitable entities described in section 501(c)(3) of the Code must do so.<sup>33</sup> All organizations, however, have the burden of proof of demonstrating that they are qualified for tax exemption.<sup>34</sup>

If the organization qualifies for tax-exempt status under a particular section of the Internal Revenue Code and applies for recognition of exemption, the IRS will issue a favorable ruling or determination letter. In general, such a ruling or determination recognizing the organization's status is effective as of the date of formation<sup>35</sup> of the organization if, during the period prior to the date of ruling or determination letter, the organization's purposes and activities were in conformity with the law.<sup>36</sup> A ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with the grounds upon which the exemption was granted, in the character, the purpose or the method of operation of the organization.<sup>37</sup>

### B. *Basic Requirements for Exemption under Section 501(c)(3)*

Nearly all nonprofit health care organizations are eligible for exemption from federal income taxation under I.R.C. § 501(c)(3).<sup>38</sup> In

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33. I.R.C. § 508. This requirement is not imposed on churches and certain church-related organizations, nor on non-private foundations with annual gross receipts of less than \$5,000. I.R.C. § 508(c)(1).

34. See, e.g., *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1071 (6th Cir. 1974).

35. That date is the date that the organization comes into existence under the law of the state in which it is formed. For a corporation, that date is usually the date the articles of incorporation are submitted to the appropriate state office. Rev. Rul. 75-290, 1975-2 C.B. 215.

36. Rev. Proc. 84-46, 1984-1 C.B. 541, 545. With limited exceptions, this is true for an entity organized after October 9, 1969, which claims tax-exempt status under I.R.C. § 501(c)(3), only if notice is given to the Commissioner that it is applying for recognition of exempt status. This notice must be given within 15 months from the end of the month in which the entity is organized. I.R.C. § 508(a); Treas. Reg. § 1.508-1(a); Rev. Rul. 77-208, 1977-1 C.B. 153. The exceptions to the above rule are for churches, certain organizations affiliated with churches, non-private foundations with annual gross receipts of \$5,000 or less, and such educational and other organizations as the IRS may specifically except. I.R.C. § 508(c).

37. Treas. Reg. § 1.501(a)-1(a)(2).

38. I.R.C. § 501(c)(3) grants tax-exempt status to:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)),



addition, a small number of "cooperative hospital service organizations" affiliated with tax-exempt hospitals are generally treated as organizations described in section 501(c)(3), pursuant to section 501(e).<sup>39</sup>

The requirements an organization must satisfy to qualify for tax exemption as a charitable entity are quite stringent. Careful attention must be paid to these requirements in both the planning and operational stages of a charity's existence. These requirements are outlined below.

### 1. *Charitable Purposes*

Section 501(c)(3) provides tax-exempt status to organizations "organized and operated exclusively for religious, charitable, scientific, . . . , or educational purposes." Although some nonprofit hospitals may be eligible to qualify for exemption as organizations organized and operated exclusively for scientific or educational purposes, the vast majority of hospitals qualify as organizations organized and operated exclusively for charitable purposes. As discussed, the promotion of health is recognized by the IRS as a charitable purpose.<sup>40</sup>

The applicable Treasury Regulations require that an organization be both organized and operated exclusively for one or more of the purposes specified in section 501(c)(3) to qualify for exemption under that section.<sup>41</sup> If an organization fails to meet either the "organizational test" or the "operational test," the organization is not described in section 501(c)(3).<sup>42</sup>

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and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

*Id.*

39. "Cooperative Hospital Service Organizations" are deemed to be charitable organizations. I.R.C. § 501(e). They are not private foundations. I.R.C. §§ 170(b)(1)(A)(iii) and 509(a)(1). They must be organized and operated solely for two or more tax-exempt member hospitals and must be organized and operated on a cooperative basis. They must perform only certain services specified in I.R.C. § 501(e)(1)(A) on a centralized basis for their members, namely, data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, records center, and personnel (including selection, testing, training and education of personnel) services. To qualify, these services must constitute exempt activities if performed by a participating hospital on its own behalf. See Rev. Rul. 69-633, 1969-2 C.B. 121. See generally Tuthill, *Qualifying as a Tax Exempt Cooperative Hospital Service Organization*, 50 NOTRE DAME LAW. 448 (1975).

40. See *supra* notes 11 and 16 and accompanying text.

41. Treas. Reg. § 1.501(c)(3)-1(a)(1).

42. *Id.*

## 2. *The Organizational Test*

To qualify for exemption as a charitable entity, the organization must be organized exclusively for one or more of the allowable exempt purposes.<sup>43</sup> The organization's articles of organization and operating rules (usually its bylaws) must be drafted in light of this requirement. These documents may not empower the organization to engage, other than insubstantially, in activities not in furtherance of the organization's exempt purposes.<sup>44</sup> Furthermore, the articles of organization must limit the organization's purposes to those described in section 501(c)(3).<sup>45</sup> Hospitals organized exclusively for the purpose of providing hospital care and thus promoting health, qualify as being organized in furtherance of a charitable purpose.<sup>46</sup>

## 3. *The Operational Test*

To qualify for exemption as a charitable entity, the organization must be operated exclusively for one or more of the allowable exempt purposes.<sup>47</sup> An organization will be regarded as satisfying this test if it is engaged "primarily" in activities in furtherance of its exempt purposes.<sup>48</sup> If more than an insubstantial part of its activities are not in furtherance of its exempt purpose, the organization will fail the operational test.<sup>49</sup>

## 4. *Serving a Public Interest*

An organization is deemed not organized and operated exclusively for charitable purposes if it serves a private interest rather than a public interest.<sup>50</sup> The organization must demonstrate that it is not organized or operated for the benefit of "private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."<sup>51</sup> Thus, a tax-exempt hospital must be organized and operated so as to benefit the community or

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43. Treas. Reg. § 1.501(c)(3)-1(b).

44. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(b).

45. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(a).

46. See *supra* notes 11 and 16 and accompanying text.

47. Treas. Reg. § 1.501(c)(3)-1(c)(1).

48. *Id.*

49. *Id.* Better Business Bureau v. United States, 326 U.S. 279, 283 (1945).

50. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

51. *Id.*

public as a whole and not to directly or indirectly benefit any designated private individuals.

With respect to the patients served, this does not mean that a tax-exempt hospital must benefit all members of the community including indigents unable to pay for health care. Rather, in the words of the IRS:

The promotion of health, like the relief of poverty and the advancement of education and religion, is one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members of the community, provided that the class is not so small that its relief is not of benefit to the community. . . . By operating an emergency room open to all persons and by providing hospital care for all those persons in the community able to pay the cost thereof either directly or through third party reimbursement, [the] Hospital . . . is promoting the health of a class of persons that is broad enough to benefit the community.<sup>52</sup>

Subsequently, the Service recognized the tax-exempt status of a hospital even though it had no emergency room and did not serve non-paying indigents.<sup>53</sup> It had no such facility because of a state health planning agency's determination that another emergency room was not needed in the area. The Service reasoned as follows:

Generally, operation of a full-time emergency room providing emergency medical services to all members of the public regardless of their ability to pay for such services is strong evidence that a hospital is operating to benefit the community. Nevertheless, there are other significant factors that may be considered in determining whether a hospital promotes the health of a class of persons broad enough so that the community benefits.<sup>54</sup>

Among these other factors were a board of directors representative of the community, an open medical staff policy, treatment of persons paying their bills with the aid of public programs such as Medicare and Medicaid, and the use of any financial surplus to improve facilities, equipment, patient care, medical training, education and research.<sup>55</sup>

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52. Rev. Rul. 69-545, 1969-2 C.B. at 118. This particular portion of this Revenue Ruling has been unsuccessfully attacked in lawsuits brought by indigents and health and welfare organizations. See, e.g., *Simon v. Eastern Ky. Welfare Rights Org.*, 426 U.S. 26 (1976); *Lugo v. Miller*, 640 F.2d 823 (6th Cir. 1981).

53. Rev. Rul. 83-157, 1983-2 C.B. 94.

54. *Id.*

55. *Id.* at 95.

### C. *Private Inurement*

Because most charities have as a major purpose the assistance of groups of people having some need, nearly all charities serve the "private interests" of their beneficiaries. Universities serve the private interests of their students and hospitals serve the private interests of their patients. Thus, the definition of "private interests" for the purpose of this test must be narrow enough to permit charitable organizations to serve the intended beneficiary class, but not allow benefits to accrue to "persons having a personal and private interest in the activities of the organization."<sup>56</sup>

An organization is not organized exclusively for exempt purposes if, under either its articles of organization or governing state law, its assets can be distributed, upon dissolution, to its members or shareholders.<sup>57</sup> In general, a charity's governing instrument should direct that, upon dissolution, the organization's assets be distributed to one or more exempt organizations or a government instrumentality to be used for exempt and/or public purposes.<sup>58</sup>

An organization is not operated exclusively for exempt purposes if there is improper private inurement of the organization's net earnings to its shareholders or other individuals having a personal and private interest in the activities of the organization.<sup>59</sup> The individuals who are thus prohibited from receiving a charity's funds are generally "insiders" who have the ability to influence the actions of the charity so as to cause the benefit.<sup>60</sup> This prohibition does not, however, bar arms-length transactions involving reasonable payments to such insiders for goods or services.<sup>61</sup>

Hospitals must always be vigilant to assure that their activities do not give rise to impermissible private inurement. Private inurement can occur, directly or indirectly, in many different ways. Hospitals should pay particular attention to the following areas.

#### 1. *Compensation for Services*

Excessive compensation of employees, directors, or others for

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56. Treas. Reg. § 1.501(a)-1(c).

57. Treas. Reg. § 1.501(c)(3)-1(b)(4). One form of *de minimis* exception is included in *University of Md. Physicians, P.A. v. Commissioner*, 41 T.C.M. 732 (1981) (although each shareholder receives \$1 for his or her stock upon dissolution, the organization is organized exclusively for charitable purposes).

58. Treas. Reg. § 1.501(c)(3)-1(b)(4).

59. Treas. Reg. § 1.501(c)(3)-1(c)(2). See also Treas. Reg. § 1.501(a)-1(c).

60. *Sound Health Ass'n v. Commissioner*, 71 T.C. 158, 185 (1978).

61. IRS EXEMPT ORGANIZATIONS HANDBOOK (IRM 7751) § 342.1(3).

services provided constitutes private inurement.<sup>62</sup> The determination as to what constitutes excessive compensation must be made in the context of the facts and circumstances of each case. Generally, if the absolute dollar amount paid to an individual is not greater than he or she could receive for his services on the open market, the amount is not excessive.<sup>63</sup>

## 2. *Equity Distribution*

Where the amount of compensation is reasonable, but is based upon the income of the hospital or of a given department, the IRS may assert that such payments are distributions based upon equity and thus constitute private inurement. The IRS unsuccessfully made this contention in three cases involving compensation of faculty/staff physicians at teaching hospitals associated with medical schools.<sup>64</sup> In earlier cases, the IRS had generally prevailed when it made this contention.<sup>65</sup> In light of those earlier cases, the Service ruled that computing a physician's compensation based on a percentage of gross income does not constitute private inurement where: (1) the compensation is reasonable; (2) the compensation agreement was negotiated at arms-length; (3) the physician is not given a percentage of the income of the entire hospital or of a similarly large income base which bears no relation to the services provided by the physician; and, (4) the physician does not control or have authority over the hospital.<sup>66</sup>

In addition to a prohibition against indirect payments based upon equity, other more direct methods of distributing equity also constitute impermissible private inurement. For example, where a charity in corporate form has shareholders, no dividend payments may be made.<sup>67</sup> Gifts and other outright transfers of a hospital's assets also constitute private inurement. Where a hospital trans-

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62. See, e.g., *Harding Hosp., Inc. v. United States*, 505 F.2d 1068 (6th Cir. 1974).

63. E.g., Rev. Rul. 69-383, 1969-2 C.B. 113, 114.

64. *University of Md. Physicians, P.A. v. Commissioner*, 41 T.C.M. 732 (1981); *University of Mass. Medical School Group Practice v. Commissioner*, 74 T.C. 1299 (1980); *B.H.W. Anesthesia Found. v. Commissioner*, 72 T.C. 681 (1979).

65. *Sonora Community Hosp. v. Commissioner*, 46 T.C. 519 (1966), *aff'd per curiam*, 397 F.2d 814 (9th Cir. 1968); *Lorain Ave. Clinic v. Commissioner*, 31 T.C. 141 (1958). However, in these early cases, the hospitals involved were not large teaching hospitals but smaller hospitals controlled by a group of founding physicians.

66. Rev. Rul. 69-383, 1969-2 C.B. at 114. See also *Harding Hosp., Inc.*, 505 F.2d at 1078 (payments to physicians' group for supervision of pharmacy and laboratory held analogous to impermissible payment of percentage of income).

67. *Birmingham Business College, Inc. v. Commissioner*, 276 F.2d 476 (5th Cir. 1960).

ferred ownership of a profit-making pharmacy to its founders, the shareholder-trustees, it was held that private inurement existed and the hospital's tax-exempt status was revoked.<sup>68</sup>

### 3. *Rentals and Sales*

The below-market value rental or sale of hospital property to staff physicians or to organizations in which staff physicians have a direct or indirect interest may, either alone or in combination with other factors, justify a finding of private inurement.<sup>69</sup> However, no private inurement exists where such below-market value rental: (1) is provided primarily for the convenience and benefit of the hospital; (2) is justified by the physician's duties at the hospital; and, (3) in combination with all other relevant transactions does not constitute excessive compensation.<sup>70</sup>

### 4. *Joint Ventures with Commercial Entities*

The potential for private inurement is ever-present when a charity and a taxable entity or individual become involved in a partnership or joint venture. Most of these ventures involving hospitals are in the development of real estate or the acquisition and operation of major medical equipment.<sup>71</sup>

### 5. *Loans*

The provision by a hospital of below-market rate loans or insufficiently secured loans to an insider or his or her relatives constitutes private inurement.<sup>72</sup> However, such loans may be made where they are necessary to induce a physician to join a hospital staff.<sup>73</sup>

### 6. *Domination by Physicians' Group*

The domination, control or near monopoly of the services provided at a hospital by a physicians' group has caused the IRS and

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68. *Maynard Hosp. v. Commissioner*, 52 T.C. 1006 (1969).

69. *Harding Hosp., Inc.*, 505 F.2d at 1078.

70. *Olney v. Commissioner*, 17 T.C.M. 982 (1958); Priv. Ltr. Rul. 8134021 (lease of land for \$1 per year to unrelated organization, which will build medical office building to be used by staff physicians, did not constitute impermissible private inurement).

71. See *infra* notes 196-211 and accompanying text.

72. *Lowry Hosp. Ass'n v. Commissioner*, 66 T.C. 850 (1976).

73. Priv. Ltr. Ruls. 8419071, 8028011 and 8418003. Private Letter Rulings may not be used or cited as precedent. I.R.C. § 6110(j)(3). At most, then, Private Letter Rulings provide guidance as to the current thinking of the IRS on a given subject.

the courts to examine closely the financial and other arrangements to ensure that no private inurement has occurred.<sup>74</sup> The *de facto* or *de jure* exclusion of qualified doctors from hospital privileges may give rise to scrutiny where the restrictions are not reasonable with respect to the hospital's available facilities and the extent of the use thereof.<sup>75</sup>

### 7. Care of Non-Paying Indigents

Whether and to what extent a hospital provides both emergency and non-emergency health care to indigents affects the way in which cases involving potential private inurement are interpreted. Although the amount of such free care provided does not necessarily correlate directly with the existence or extent of private inurement, both the IRS and the courts seem to view low levels of free care provided as an indicator of a non-charitable, physician-income maximizing orientation, whereas high levels of free care indicate that the physicians are more concerned with the patient's health than their own financial gain. Thus, in the former cases, private inurement is more likely to be found than in the latter.

### D. Lobbying and Political Activities

Tax-exempt charities may not be permitted by their governing instruments to engage in,<sup>76</sup> and may not actually engage in<sup>77</sup> (1) the substantial influencing of legislation by propaganda or otherwise;<sup>78</sup> or (2) direct or indirect participation or intervention, including the publishing or distributing of statements, in any political campaign on behalf of or in opposition to any candidate for public office.<sup>79</sup> An organization is not a charity if its main objective(s) may be attained only through the passage or defeat of legislation and it actively campaigns on behalf of the main objective(s) rather than merely engaging in the distribution of nonpartisan analysis, study or research.<sup>80</sup>

Proscribed legislative activities include (1) "any attempt to influence any legislation through an attempt to affect the opinion of the

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74. *Harding Hosp., Inc.*, 505 F.2d at 1078; *Lowry Hosp. Ass'n*, 66 T.C. at 859; Rev. Rul. 56-185, 1956-1 C.B. 202, 203.

75. Rev. Rul. 56-185, 1956-1 C.B. 202.

76. Treas. Reg. § 1.501(c)(3)-1(b)(3).

77. Treas. Reg. § 1.501(c)(3)-1(c)(3).

78. Treas. Reg. §§ 1.501(c)(3)-1(b)(3)(i), 1.501(c)(3)-1(c)(3)(ii).

79. Treas. Reg. §§ 1.501(c)(3)-1(b)(3)(ii), 1.501(c)(3)-1(c)(3)(iii).

80. Treas. Reg. § 1.501(c)(3)-1(c)(3)(iv).

general public or any segment thereof,”<sup>81</sup> and (2) “any attempt to influence any legislation through communication with any member or employee of a legislative body or with any government official or employee who may participate in the formulation of the legislation. . . .”<sup>82</sup>

Activities that are not prohibited, however, include (1) providing technical advice or assistance (otherwise constituting the influencing of legislation) to a governmental body or to a committee or individual legislator in response to a written request by such body, committee or individual;<sup>83</sup> (2) appearing before or communicating with any legislative body with respect to a possible decision of that body that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to the organization;<sup>84</sup> and (3) communicating with a government official or employee other than: (i) a communication with a member or employee of a legislative body that would constitute the influencing of legislation or (ii) a communication with the principal purpose of influencing legislation.

Although charities other than private foundations<sup>85</sup> are allowed to engage in an insubstantial amount of lobbying, it is difficult to determine what constitutes more than “insubstantial.”<sup>86</sup> For that reason, some charities avoid engaging in any legislative activities (unless those legislative activities are clearly permitted) and instead use an affiliated organization described in I.R.C. § 501(c)(4) or (c)(6) to accomplish legislative objectives.<sup>87</sup>

Federal tax law precludes charitable organizations from “participating in, or intervening in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.”<sup>88</sup> The IRS views this rule as an absolute prohibition.<sup>89</sup>

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81. I.R.C. § 4945(e)(1).

82. I.R.C. § 4945(e)(2).

83. *Id.* See also Rev. Rul. 70-449, 1970-2 C.B. 111.

84. I.R.C. § 4945(e).

85. See *infra* notes 90-109 and accompanying text.

86. I.R.C. § 501(h) permits most “public charities,” i.e., non-private foundations, including hospitals, to elect special “safe-harbor” guidelines as to permissible legislative activities.

87. See generally Treas. Reg. 1.501(c)(3)-1(c)(3)(v). I.R.C. § 501(c)(4) describes certain tax-exempt social welfare organizations. I.R.C. § 501(c)(6) describes certain tax-exempt “business leagues.”

88. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(3).

89. IRS EXEMPT ORGANIZATION HANDBOOK (IRM 7751) § 3(10)(1).



### E. *Public Charity Versus Private Foundation Status*

Every charitable organization is presumed to be a "private foundation"<sup>90</sup> with that presumption rebutted where the organization is either a public institution "publicly supported" or a "supporting organization."<sup>91</sup> Generally, a private foundation is a charitable organization that is funded from one source, derives its operating revenue from its investment earnings, and makes grants rather than conducts its own programs. Public charities generally have broad public support or are devoted to actively supporting a charity which is publicly supported.<sup>92</sup>

Public charity status is far more favorable than private foundation status. Public charities are permitted to receive tax deductible charitable contributions on terms more favorable to the donor than are private foundations.<sup>93</sup> Private foundations must pay an excise tax of two per cent of their annual net investment income,<sup>94</sup> and are subject to strict rules and potentially severe penalties and taxes regarding the use of their funds and other matters.<sup>95</sup>

Hospitals are fortunate in that they, and nearly all organizations affiliated with them, can qualify for public charity status.<sup>96</sup> Organizations are deemed not to be private foundations, i.e., deemed to be public charities, by reason of the nature of their program activities, receipt of gifts from the general public, receipt of "exempt function revenue," or their status as "supporting organizations."<sup>97</sup>

Organizations that are not private foundations by virtue of the inherent nature of their programs include churches, educational organizations, organizations operated for the benefit of certain state and municipal colleges, and governmental units.<sup>98</sup> This category of non-private foundations also includes hospitals and certain medical research organizations that are affiliated with hospitals. The term "hospital," while not specifically defined in the statutory

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90. I.R.C. § 508(b), (c).

91. I.R.C. § 509(a).

92. Public safety testing organizations described in I.R.C. § 509(a)(4) are also deemed not to be private foundations. *See also supra* note 28.

93. I.R.C. § 170(b)(1)(E).

94. I.R.C. § 4940(a).

95. *E.g.*, I.R.C. §§ 4941-4945.

96. I.R.C. §§ 509(a)(1) and 170(b)(1)(A)(iii) describe hospitals as non-private foundations. Organizations affiliated with hospitals generally qualify for non-private foundation status either as independent, publicly-supported organizations described in I.R.C. § 509(a)(2) or as organizations supporting the hospital as described in I.R.C. § 509(a)(3).

97. I.R.C. § 509(a).

98. I.R.C. §§ 509(a)(1), 170(b)(1)(A)(i)-(v).

law, is somewhat defined in the statute by reason of the requirement that a "hospital" have as its "principal purpose or functions . . . the providing of medical or hospital care or medical education or medical research."<sup>99</sup> The regulations bring within the ambit of the term "hospital" many different types of institutions, including governmental hospitals, rehabilitation institutions, outpatient clinics, community mental health centers, drug treatment centers, and certain extended care facilities. Excluded from the definition are convalescent homes, homes for children or the aged, and institutions, the principal purpose or function of which is to train handicapped individuals to pursue a vocation.<sup>100</sup> However, an organization, the principal purpose or function of which is the provision of medical education or medical research, is not considered a "hospital" unless "it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities, on an inpatient or outpatient basis, as an integral part of its medical education or medical research functions."<sup>101</sup> More extensive rules have been promulgated concerning the meaning and scope of the term "medical research organization."<sup>102</sup>

By definition, public charities also can include charitable organizations that normally receive a substantial portion of their support (exclusive of income received in the exercise or performance by the organization of its exempt purposes) in the form of grants from a governmental unit or contributions (direct or indirect) from the general public.<sup>103</sup> Generally, at least one-third of an organization's support must be derived from public gifts to be classified as a public charity.<sup>104</sup>

The public charity classification is also available to charitable organizations which normally receive more than one-third of their support from any combination of exempt function revenue as well as public gifts, grants and membership fees, and which normally receive no more than one-third of their support from gross investment income and any amount of unrelated business taxable income in excess of any unrelated income tax paid.<sup>105</sup>

The fourth category of non-private foundation is the so-called

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99. I.R.C. § 170(b)(1)(A)(iii).

100. Treas. Reg. § 1.170A-9(c)(1).

101. *Id.*

102. Treas. Reg. § 1.170A-9(c)(2).

103. I.R.C. §§ 509(a)(1), 170(b)(1)(A)(vi).

104. Treas. Reg. § 1.170A-9(e).

105. I.R.C. § 509(a)(2).

"supporting organization." A qualified supporting organization is one that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more public charities<sup>106</sup> (including hospitals). The supporting organization must be operated, supervised, or controlled by or in connection with one or more public charities<sup>107</sup> and it must not be controlled by one or more disqualified persons<sup>108</sup> with respect to it. A hospital or a hospital affiliated medical research organization constitutes a qualified supported organization under these rules.<sup>109</sup>

#### F. *Conduct of Unrelated Trade or Business*

As noted above, to be tax-exempt, an organization must be organized and operated exclusively for charitable purposes.<sup>110</sup> The federal tax law, however, allows an exempt organization to engage in a certain amount of activity unrelated to its exempt purposes.<sup>111</sup> Where the organization derives net income from one or more unrelated business activities, known as "unrelated business taxable income,"<sup>112</sup> it is subject to tax on such income. An organization's exemption will be revoked if an inappropriate portion of its activities is not in furtherance of an exempt purpose.<sup>113</sup> An unrelated trade or business, although carried on for profit, need not result in profit.<sup>114</sup>

Business activities may preclude initial qualification of an otherwise exempt organization as a charitable entity.<sup>115</sup> This would occur through its failure to satisfy the operational test.<sup>116</sup> Likewise, an organization will not meet the organizational test if its articles of organization empower it, as more than an insubstantial part of its activities, to carry on activities that are not in furtherance of its exempt purpose.<sup>117</sup>

An organization may nonetheless satisfy the operational test even when it operates a trade or business as a substantial part of

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106. I.R.C. § 509(a)(1) or (2) describes such organizations.

107. See I.R.C. § 509(a)(3).

108. I.R.C. § 509(a)(3)(C).

109. I.R.C. § 509(a)(3)(A), (B).

110. See *supra* notes 11 and 16 and accompanying text.

111. Treas. Reg. § 1.501(c)(3)-1(e)(1).

112. I.R.C. §§ 511-13. See also I.R.C. § 501(b).

113. Treas. Reg. § 1.501(c)(3)-1(c)(1).

114. I.R.C. § 513(c).

115. *Id.*

116. See *supra* text accompanying notes 47-49.

117. See *supra* text accompanying notes 43-46.

its activities, provided the trade or business is in furtherance of the organization's exempt purpose and the organization is not operated for the primary purpose of carrying on an unrelated trade or business.<sup>118</sup> If the organization's primary purpose is carrying on a trade or business for profit, it is expressly denied exemption on the ground that it constitutes a "feeder organization."<sup>119</sup> This is true notwithstanding the fact that all of its profits are payable to one or more tax-exempt organizations.

Tax-exempt organizations are subject to tax on their unrelated business taxable income at ordinary corporate tax rates or at individual rates if the organization is not incorporated.<sup>120</sup> Unrelated business taxable income is gross income from any unrelated trade or business regularly carried on, less deductions directly connected with that business, and subject to a number of modifications.<sup>121</sup>

The objective of the unrelated business income tax is to prevent unfair competition between tax-exempt organizations and for-profit, commercial enterprises.<sup>122</sup> The rules are intended to place the unrelated business activities of an exempt organization on the same tax basis as the non-exempt business with which it competes.<sup>123</sup>

### 1. *Elements Necessary for Tax Liability*

The net income of a tax-exempt organization, derived from an activity that is a regularly carried on trade or business which is not substantially related to the performance of the exempt organization's exempt functions, will be taxable as unrelated business taxable income (absent the application of a statutory exception).<sup>124</sup> Each of the following three elements must be independently satisfied for tax liability to arise: (1) there must be a trade or busi-

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118. Treas. Reg. § 1.501(c)(3)-1(c)(1).

119. I.R.C. § 502.

120. I.R.C. § 511.

121. I.R.C. § 512.

122. Treas. Reg. § 1.513-1(b).

123. *Id.* See also *Disabled American Veterans v. United States*, 650 F.2d 1178, 1185-87 (Ct. Cl. 1981), *aff'd*, 704 F.2d 1570 (Fed. Cir. 1983); *Hope School v. United States*, 612 F.2d 298, 303-04 (7th Cir. 1980). *But see* *Clarence La Belle Post No. 217 v. United States*, 580 F.2d 270, 272-74 (8th Cir.), *cert. denied*, 439 U.S. 1040 (1978); *Professional Ins. Agents of Mich. v. Commissioner*, 78 T.C. 246 (1982), *aff'd*, 726 F.2d 1097 (6th Cir. 1984); *Louisiana Credit Union League v. United States*, 501 F. Supp. 934, 938-39 (E.D. La. 1980), *aff'd*, 693 F.2d 525 (5th Cir. 1982); *Smith-Dodd Businessman's Ass'n v. Commissioner*, 65 T.C. 620, 624 (1975).

124. Treas. Reg. § 1.513-1(a).

ness;<sup>125</sup> (2) the trade or business must be carried on regularly;<sup>126</sup> and (3) the business activity must be unrelated to the exempt purposes and functions of the organization.<sup>127</sup>

*Trade or Business.* Under the general rules, any activity which is carried on for the production of income from the sale of goods or the performance of services constitutes a "trade or business."<sup>128</sup> Accordingly, most activities which would constitute a trade or business under basic tax law principles<sup>129</sup> are considered a trade or business for purposes of the unrelated income rules.<sup>130</sup>

Under a "fragmentation principle" an "activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."<sup>131</sup> An example is the sale of pharmaceutical supplies to the general public by a hospital pharmacy which otherwise serves the hospital's needs.<sup>132</sup>

There is a split of authority as to whether an activity must pose a threat of unfair competition in order to constitute a trade or business for purposes of determining unrelated business taxable income. Some courts have held the presence of such unfair competition to be a key factor,<sup>133</sup> whereas other courts have held that it is only a minor factor<sup>134</sup> or that it is not to be considered at all.<sup>135</sup>

Activities confined to the production of passive income generally do not constitute a trade or business,<sup>136</sup> just as the mere management of an investment portfolio does not constitute a trade or business under general law principles.<sup>137</sup> The exemption of passive income is in recognition of the fact that it has long been the custom for hospitals, and other tax-exempt organizations, to finance their operations from the investment income earned on endowments and

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125. Treas. Reg. § 1.513-1(b).

126. Treas. Reg. § 1.513-1(c).

127. Treas. Reg. § 1.513-1(d).

128. I.R.C. § 513(c).

129. I.R.C. § 162.

130. Treas. Reg. § 1.513-1(b).

131. I.R.C. § 513(c).

132. Treas. Reg. § 1.513-1(b).

133. *Disabled American Veterans*, 650 F.2d at 1185-87; *Hope School*, 612 F.2d at 303-04; *Professional Ins. Agents of Mich.*, 78 T.C. at 264.

134. *Clarence La Belle Post*, 580 F.2d at 272-74; *Professional Ins. Agents of Mich.*, 78 T.C. at 264; *Smith-Dodd Businessman's Ass'n*, 65 T.C. at 624.

135. See *Louisiana Credit Union League*, 501 F. Supp. at 938-39.

136. Rev. Rul. 69-574, 1969-2 C.B. 130.

137. *Higgins v. Commissioner*, 312 U.S. 212 (1941); Rev. Rul. 56-511, 1956-2 C.B. 170.

other contributions.

However, the exemption for passive income does not extend to (1) income from debt-financed property,<sup>138</sup> (2) interest, annuities, rents, and royalties from a controlled corporation (i.e., 80 percent or more control of voting stock),<sup>139</sup> or (3) the organization's share of the earnings of a partnership engaged in a business.<sup>140</sup> These exclusions are intended to remove the incentive for the shifting of productive property unrelated to an exempt purpose into the exempt sector in an attempt to shelter business income from taxation.

*Regularly Carried On.* Income from an activity is considered taxable only when, assuming the other criteria are satisfied, the activity is regularly carried on, as distinguished from sporadic or infrequent commercial transactions.<sup>141</sup> The factors which determine whether an activity is regularly carried on are the frequency and continuity of the activities, and the manner in which the activities are pursued.<sup>142</sup>

These factors must be evaluated in light of the purpose of the unrelated business income tax to place tax-exempt organizations' business activities upon the same tax basis as their nonexempt business competitors.<sup>143</sup> Thus, specific business activities of a tax-exempt organization will generally "be deemed . . . 'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations."<sup>144</sup>

Where income-producing activities are performed by commercial organizations on a year-round basis, the performance of those activities for a period of only a few weeks does not constitute the regular carrying on of a trade or business.<sup>145</sup> For example, the operation of a sandwich stand by a hospital auxiliary for only two weeks at a state fair does not constitute the regular conduct of

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138. I.R.C. § 514.

139. I.R.C. § 512(b)(13). See Treas. Reg. § 1.512(b)-1(a); J.E. and L.E. Mabey Found., Inc. v. United States, 533 F.2d 521 (10th Cir. 1976); United States v. Robert A. Welch Found., 334 F.2d 774 (5th Cir. 1964).

140. Service Bolt & Nut Co. v. Commissioner, 724 F.2d 519 (6th Cir. 1983). But see Plumstead Theatre Soc'y, Inc. v. Commissioner, 74 T.C. 1324 (1980), *aff'd per curiam*, 675 F.2d 244 (9th Cir. 1982).

141. Treas. Reg. § 1.513-1(c).

142. Treas. Reg. § 1.513-1(c)(1).

143. *Id.*

144. *Id.*

145. Treas. Reg. § 1.513-1(c)(2)(i).

business.<sup>146</sup> Similarly, occasional or annual income-producing activities, such as fund-raising events, do not constitute a business regularly carried on.<sup>147</sup> However, the conduct of year-round business activities, such as parking lot rental, for one day each week would constitute the regular carrying on of a business.<sup>148</sup> Where commercial entities normally undertake income-producing activities on a seasonal basis, the conduct of the activities by an exempt organization during a significant portion of the season is deemed the regular conduct of that activity.<sup>149</sup>

A trade or business is regularly carried on if the attributes of the activity are similar to the commercial activities of nonexempt organizations.<sup>150</sup> A hospital pharmacy with only occasional, casual sales to nonpatients, which is conducted without the competitive and promotional efforts typical of a commercial endeavor, is not deemed to be a regularly conducted trade or business.<sup>151</sup>

*Substantially Related.* A regularly conducted trade or business is subject to tax, unless it is substantially related to the accomplishment of the organization's exempt purpose.<sup>152</sup> The mere production of income to support the exempt purposes of an organization is not considered an adequate basis for deeming the activity to be related.<sup>153</sup> To be substantially related, the activity must have a substantial causal relationship to the achievement of an exempt purpose.<sup>154</sup>

The fact that an asset is essential to the conduct of the organization's exempt activities does not shield the commercial income from taxation where that income was produced by that asset.<sup>155</sup> The income-producing activities must still meet the causal relationship test if the income is not to be subject to tax.<sup>156</sup> This issue

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146. *Id.*

147. S. REP. No. 2375, 81st Cong., 2d Sess., reprinted in 1950 U.S. CODE CONG. & AD. NEWS 3053, 3165; Priv. Ltr. Rul. 8428094.

148. Treas. Reg. § 1.513-1(c)(2)(i).

149. *Id.* See also Rev. Rul. 68-505, 1968-2 C.B. 248.

150. Treas. Reg. § 1.513-1(c).

151. Rev. Rul. 68-374, 1968-2 C.B. 242. See also Priv. Ltr. Rul. 8152007 (pap tests for nonpatients do not give rise to unrelated business income because, in part, the tests are not conducted in a commercial manner for profit). But see Rev. Rul. 68-375, 1968-2 C.B. 245 (a hospital pharmacy located in a medical office building and selling primarily to nonpatients is an unrelated business).

152. Treas. Reg. § 1.513-1(a).

153. I.R.C. § 513(a).

154. Treas. Reg. § 1.513-1(d)(2).

155. See Treas. Reg. § 1.513-1(d).

156. Treas. Reg. § 1.513-1(d)(2).

arises when an organization owns a facility or other assets that are put to dual use. For example, the operation of an auditorium as an ordinary movie theatre for public entertainment in the evening would be treated as an unrelated activity even though the theatre is used exclusively for exempt purposes during regular hours.<sup>157</sup>

A related concept is that activities should not be conducted on a scale larger than is reasonably necessary for the performance of the exempt functions.<sup>158</sup> Those activities in excess of the needs of exempt functions constitute the conduct of an unrelated business.<sup>159</sup>

*Exceptions.* Even where an activity would be treated as an unrelated activity by reason of these requirements, there are certain exceptions to the general rule. With respect to health care organizations, the following are the relevant situations in which there is an available exception to the general rule regarding the conduct of an unrelated trade or business:

1) substantially all of the work in carrying on the trade or business is performed by volunteers (without compensation);<sup>160</sup>

2) the trade or business is carried on primarily for the convenience of the organization's members, students, patients, officers or employees;<sup>161</sup>

3) the trade or business is the sale of merchandise, substantially all of which was donated to the organization;<sup>162</sup> or,

4) the trade or business is the provision, at or below cost,<sup>163</sup> of certain services to hospitals described in I.R.C. § 170(b)(a)(A)(iii) which have facilities to serve fewer than 100 inpatients.<sup>164</sup>

## 2. *Examples of Related and Unrelated Trade or Business Activities*

Most of the decisions regarding the applicability or non-applica-

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157. *Id.*

158. Treas. Reg. § 1.513-1(d)(3).

159. *Id.*

160. Treas. Reg. § 1.513-1(e)(1).

161. Treas. Reg. § 1.513-1(e)(2). *See also* Priv. Ltr. Rul. 8411093 (income from CAT scans for hospital patients is not unrelated business income because, in part, the scans are performed for the convenience of patients within the meaning of I.R.C. § 513(a)(2)).

162. Treas. Reg. § 1.513-1(e)(3).

163. Treas. Reg. § 1.513-6(a)(3). *See infra* notes 269-73 and accompanying text.

164. Treas. Reg. § 1.513-6. The services which may be provided are those described in I.R.C. § 501(e)(1)(A): data processing, purchasing, warehousing, billing and collection, food, clinical, industrial, engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training and education of personnel) services. I.R.C. § 501(e)(1)(A); I.R.C. § 513(e).



bility of the unrelated business income tax are decided on the basis of whether the activities are substantially related to the exempt purposes. Hence, there are many published rulings, especially private letter rulings, regarding this topic. For purposes of this analysis, the relevant decisions and rulings are placed into several categories which apply to nonprofit health care organizations.

*Gift Shops.* A hospital gift shop supplying patients and hospital employees as well as visitors making purchases for patients with candy, reading material, and other small gift items qualifies as related to the achievement of the hospital's exempt purpose. "By providing a facility for the purchase of merchandise and services to improve the physical comfort and mental well-being of its patients, the hospital is carrying on an activity that encourages their recovery" and this contributes importantly to the exempt purpose of providing health care for members of the community.<sup>165</sup> The sales to employees are also related because they increase the hospital's operating efficiency by keeping the staff on the premises throughout their working hours.<sup>166</sup>

*Cafeterias and Coffee Shops.* Operation of a cafeteria and coffee shop within the hospital for employees is a related activity because of the efficiency factor cited with respect to gift shops.<sup>167</sup> The shop also may serve visitors of patients without incurring sanctions because "[v]isitation of patients constitutes supportive therapy that assists in patient treatment and encourages recovery."<sup>168</sup> The hospital's coffee shop enables visitors to spend more time with the patients and so contributes importantly to the exempt purpose.<sup>169</sup>

*Parking Lots.* The operation of an adjacent parking lot on a fee basis by a hospital is related to its exempt purpose if adequate parking space is not available for patients and visitors.<sup>170</sup> The hospital's operation of the lot encourages visitation of patients and promotes maximum effectiveness in serving the public.<sup>171</sup>

*By-products.* Income from the disposition of products that result from performing exempt functions does not constitute income from an unrelated business if the products are sold in substantially the same state in which they are upon completion of the exempt

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165. Rev. Rul. 69-267, 1969-1 C.B. 160.

166. *Id.*

167. Rev. Rul. 69-268, 1969-1 C.B. 160.

168. *Id.*

169. *Id.*

170. Rev. Rul. 69-269, 1969-1 C.B. 160.

171. *Id.* at 161.

function.<sup>172</sup> For example, an organization whose exempt purpose is to rehabilitate handicapped individuals conducts occupational training which, as a by-product produces goods that are sold. In this case, the manufacture of goods and the operation of a retail store have a substantial causal relationship to the exempt organization's exempt purpose.<sup>173</sup> An example not involving health care is the sale of milk produced by an experimental dairy herd maintained by an exempt university's agricultural school. In this case, the sale of the milk itself would not be subject to taxation because it is related to the organization's exempt purpose.<sup>174</sup> However, if the milk is processed into ice cream or cheese and this processing does not have an educational function, the income from the sale of these products would not be related to the organization's exempt purpose.<sup>175</sup>

*Sale of Blood.* The sale of certain blood and blood components to commercial laboratories by a blood bank, in addition to carrying out its exempt purposes, is an unrelated activity where the sales are made on a regular basis.<sup>176</sup> An organization was formed to establish and operate facilities to collect and distribute human blood and blood products for the benefit of the public, as well as to conduct related research. Because the sales are not related to the organization's exempt purposes, the tax on unrelated business income applies.<sup>177</sup> However, where the blood and blood products sold to commercial laboratories are a by-product resulting from the performance of the organization's tax-exempt functions, there is no unrelated business income.<sup>178</sup>

*Goodwill.* Some exempt organizations have attempted to raise funds by merchandising their goodwill. This is accomplished by endorsing products or selling membership lists. Unless it can be demonstrated that this activity is related to the fulfillment of the organization's exempt purpose, the activity would, if regularly carried on, constitute an unrelated business subject to tax.<sup>179</sup>

*Laboratory Services.* The provision of laboratory services to hospital patients is substantially related to a hospital's exempt pur-

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172. Treas. Reg. § 1.513-1(d)(4)(ii).

173. *Id.*

174. *Id.*

175. *Id.*

176. Rev. Rul. 66-323, 1966-2 C.B. 216, as modified by Rev. Rul. 78-145, 1978-1 C.B. 169.

177. *Id.*

178. Rev. Rul. 78-145, 1978-1 C.B. 169.

179. Treas. Reg. § 1.513-1(d)(4)(iv).

poses.<sup>180</sup> When laboratory services are provided to nonpatients, particularly to the private patients of staff physicians, the services are, with certain exceptions, unrelated to the hospital's exempt purpose.<sup>181</sup>

*Pharmacy Sales.* The treatment of sales of drugs and other pharmaceutical items is very similar to the treatment of sales of laboratory services. The provision of drugs to hospital patients is substantially related to the hospital's exempt purposes.<sup>182</sup> The difficult issue, once again, arises when pharmacy items are sold to the general public or to the private patients of staff physicians. As in the case of laboratory services, the sale of drugs and other items by an exempt hospital to nonpatients is generally but not always unrelated to the hospital's exempt purposes.<sup>183</sup> If the drugs are not otherwise available, as in a rural area, their sale by an exempt hospital will not constitute an unrelated business.<sup>184</sup>

Pharmacy sales by an exempt hospital to its staff physicians' private patients may be held to be a related business where such sales are a reasonably necessary inducement to get qualified physicians to settle in and work for a community.<sup>185</sup> Once again, this is a problem, especially in rural areas, which may be overcome only by use of such incentives.

*Rental of Facilities.* In general, the leasing of space in adjacent medical office buildings to staff physicians does not constitute an unrelated trade or business. This is so because the leases are entered into primarily to further the hospital's exempt purposes.<sup>186</sup> The leasing of such office space contributes to hospital functions by increasing the hospital's efficiency, encouraging fuller utilization of facilities and improving the quality of patient care. In one revenue ruling, the IRS described this as follows:

The hospital has established that the presence of the group practice at the hospital has had the effect of (1) reducing hospital admissions, days of stay, and surgical rates; (2) permitting more efficient use of existing facilities; (3) making more effective use of scarce health manpower; (4) fulfilling the hos-

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180. I.R.C. § 513(a)(2); Rev. Rul. 68-376, 1968-2 C.B. 246. See *infra* notes 222-26 and accompanying text.

181. See *infra* notes 222-26 and accompanying text.

182. E.g., Priv. Ltr. Rul. 7831028.

183. *Hi-Plains Hosp. v. United States*, 670 F.2d 528 (5th Cir. 1982); Rev. Rul. 68-375, 1968-2 C.B. 245.

184. Priv. Ltr. Rul. 8314002.

185. See *Hi-Plains Hosp.*, 670 F.2d at 533.

186. E.g., Rev. Rul. 69-463, 1969-2 C.B. 131; Rev. Rul. 69-464, 1969-2 C.B. 132; Priv. Ltr. Ruls. 8408057 and 8408058.

pital's role as the health center of the community; (5) fixing administrative responsibility in a single group; and (6) making more effective use of hospital facilities for training purposes.<sup>187</sup>

In another revenue ruling, the Service again described the ways in which such leases furthered the hospital's purposes:

The hospital has established that (1) as a result of having members of its medical staff practicing medicine in offices adjacent to the hospital, greater use is made of the hospital's diagnostic facilities and patient admissions are easier, and (2) the physical presence of the members of the medical staff on the hospital's grounds makes the services of these doctors more readily available for outpatient and inpatient emergencies, facilitates carrying out their everyday medical duties in the hospital, makes their attendance at staff meetings easier, and serves to increase their participation in the hospital's medical education and research programs. While these leasing arrangements are also a convenience to the lessees, many of the benefits are passed on to the hospital and its patients in the form of greater efficiency and better overall medical care.<sup>188</sup>

In at least one private letter ruling, the IRS has also found that the provision of offices in a medical office building is related to a hospital's exempt purposes where the provision of office space is an inducement to attract physicians to a rural area lacking in adequate medical care.<sup>189</sup>

*Services to Other Health Care Organizations.* Generally, a hospital is subject to unrelated income taxation if it provides services to other unaffiliated tax-exempt hospitals.<sup>190</sup> However, a limited exception to the general rule allows hospitals to perform certain services, provided the services are performed at cost,<sup>191</sup> are furnished solely to tax-exempt hospitals having not more than 100 inpatients, and are consistent with the hospital's exempt purposes.<sup>192</sup> The services which may be performed are those which a cooperative hospital service organization described in section 501(e) may perform.<sup>193</sup>

As in other contexts, the provision of services otherwise unavailable in the community is substantially related to and consistent

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187. Rev. Rul. 69-463, 1969-2 C.B. at 131.

188. Rev. Rul. 69-464, 1969-2 C.B. at 132.

189. Priv. Ltr. Rul. 8403061. See generally Rev. Rul. 73-313, 1973-2 C.B. 174 (exemption recognized for organization formed by residents of isolated rural community to provide a medical building).

190. See *infra* text accompanying note 248.

191. I.R.C. § 513(e)(3). See *infra* notes 269-73 and accompanying text.

192. I.R.C. § 513(e).

193. See *supra* note 39 and accompanying text.

with the hospital's exempt purposes.<sup>194</sup> In addition, the Service has privately ruled that where a hospital treats another hospital's patient, the provision of these services does not constitute an unrelated activity because providing this type of treatment is substantially related to the hospital's exempt purposes.<sup>195</sup>

### G. *Participation in Partnerships*

The federal tax law pertaining to the participation by non-profit organizations—particularly by charitable organizations—as partners in partnerships is, indeed, cryptic.<sup>196</sup> The statutory law is clear that tax-exempt organizations may participate as partners in partnerships without loss of tax exemption.<sup>197</sup> To date, the case law and the “authority” developed in IRS private letter rulings and general counsel memoranda apply solely to charitable organizations. There is no statute, Treasury Department regulation, or published IRS revenue ruling that amplifies the subject. The law that exists, therefore, is the product of nonprecedential IRS pronouncements, and two court opinions arising out of the same case.<sup>198</sup>

At present, the position of the IRS is that there is no *per se* prohibition against a tax-exempt, charitable organization participating as a general partner in a limited partnership.<sup>199</sup> Accordingly, the IRS currently takes the position that a charitable organization will not automatically lose or be denied its tax exemption simply because it participates as a general partner in a partnership.<sup>200</sup>

In evaluating the impact of participation as a general partner by a charitable organization, the IRS first looks to determine whether

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194. Priv. Ltr. Ruls. 8305115 and 8338068. See also Priv. Ltr. Rul. 8004011.

195. Priv. Ltr. Rul. 8013052.

196. Recent commentaries on this subject include McGovern, *The Tax Consequences of a Charity's Participation as a General Partner in a Limited Partnership Venture*, 29 TAX NOTES (No. 12) 1261 (1985); Flaherty, *Exempt Organizations and Real Estate Syndications After the Tax Reform Act of 1984*, 12 JOURNAL OF COLLEGE AND UNIVERSITY LAW (No. 1) 61 (1985); Yanowitz and Purcell, *Using the Investment Partnership as a Charitable Activity: A Means/Ends Analysis*, 60 J. TAX'N 214 (1984); Schill, *The Participation of Charities in Limited Partnerships*, 93 YALE L.J. 1354 (1984); *The Charity as the General Partner in a Limited Partnership*, 17 PHILANTHROPY MONTHLY 24 (1984); Kaplan, *Real Estate Opportunities for Tax-Exempt Organizations: Potential and Pitfalls After Plumstead Theatre*, 61 TAXES (No. 5) 291 (1983).

197. See *infra* notes 276-282 and accompanying text.

198. See *Plumstead Theatre Soc'y, Inc. v. Commissioner*, 675 F.2d 244 (9th Cir. 1982), *aff'g*, 74 T.C. 1324 (1980).

199. G.C.M. 39005 (June 28, 1983). See also G.C.M. 39444 (July 18, 1985).

200. G.C.M. 39005 (June 28, 1983). See also G.C.M. 39444 (July 18, 1985).

the participation is in furtherance of the organization's tax-exempt purposes. If exempt purposes are not being furthered, or, more specifically, if participation in the partnership is in conflict with the purposes of the charitable organization, tax exemption will be revoked or denied. This threshold test has been stated as follows:

The facts and circumstances must be examined to determine whether conflicts exist that are incompatible with being organized and operated exclusively for charitable purposes. Initial focus should be on whether the organization is serving a charitable purpose. Further, if the organization is serving a private interest, other than incidentally, then its participation in a limited partnership will [adversely] affect its exempt status.<sup>201</sup>

If this threshold test is satisfied, the IRS then will examine the facts to determine whether the exempt organization is adequately "insulated" from the day-to-day obligations of a general partner and whether the limited partners are enjoying an "undue" return. If all three tests are met under the facts, the charitable organization may participate in the partnership without loss or denial of federal income tax exemption.

In a recent private letter ruling,<sup>202</sup> the IRS formulated the two tests beyond the threshold test as the "qualitative" test and the "quantitative" test. These tests address the aspect of private benefit, which is required to be both incidental and not substantial. In the ruling, the IRS stated: "In order to be incidental in a qualitative sense, it must be a necessary concomitant of the activity which benefits the public at large. In other words, the activity can be accomplished only by benefiting certain private individuals. To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity."<sup>203</sup>

Prior IRS private pronouncements have explicitly required that the charitable organization/general partner be "insulated" from the fundamental responsibilities as general partner.<sup>204</sup> While this requirement is not reflected in the qualitative and quantitative tests, the IRS noted, in the recent private letter ruling, that the partnership has "minimal operational responsibilities and duties,"<sup>205</sup> since the sole tenant assumed all operational and management functions with respect to the property, including repairs and

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201. G.C.M. 39005 (June 28, 1983). See also G.C.M. 39444 (July 18, 1985).

202. Priv. Ltr. Rul. 8541108.

203. *Id.*

204. *E.g.*, G.C.M. 39005 (June 28, 1983).

205. See *id.* See also G.C.M. 39444 (July 18, 1985).

maintenance.

Another requirement stated in prior IRS private pronouncements is that the limited partners/investors may not receive an "undue" return on their investment. This rule is not explicitly stated in this IRS ruling, although the facts state that the investors' return will be "reasonable." Also, the IRS looks to see if a variety of restrictions are in place to ensure that only persons with significant interest in the organization's programs have a partnership interest.

The IRS originally opposed any partnership where a charity was the managing general partner and private investors were limited partners, even where the partnership itself was in furtherance of charitable purposes.<sup>206</sup> Its principal objection was based upon the premise that the charity, by serving as general partner, would impermissibly serve the private interests of the investors. The Service also contended that the fiduciary duty the charity would owe to its limited partners would make the charity vulnerable to a conflict of interest between maximizing profits and achieving its charitable goals. Finally, the Service argued, charities would, as general partners, be able to compete unfairly for capital with non-exempt entities, which are not generally able to pass on so many of the tax benefits to the limited partners.

These issues were addressed in a case settled in 1980.<sup>207</sup> The case involved the tax-exempt status of an organization which, as a general partner, owned a one percent interest in a partnership, all of the other interests in which were owned by a for-profit corporate general partner, and by private individuals. The settlement allowed the organization to serve as a general partner without endangering its tax-exempt status. The organization prevailed because it showed that it had limited control and management of the project and limited involvement in the project's finances. The partnership agreement made the for-profit general partner primarily responsible for managing the financial and business aspects of the project. Hence, the IRS was able to rationalize that the exempt organization is able to work primarily in furtherance of its tax-exempt purposes (low-income housing) without having to become unduly involved in the business aspects of the partnership.<sup>208</sup>

During the period the IRS was opposing all participation in

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206. *E.g.*, Priv. Ltr. Rul. 7820058.

207. *Strawbridge Square, Inc. v. United States*, No. 471-79T (Ct. Cl.).

208. See Becker, *Partnerships with Historic Preservation Organizations in Real Estate Development*, 1 PRESERVATION LAW REPORTER (No. 4) 2052 (1982).

partnerships by charitable organizations as general partners, one organization challenged the government's position in court and prevailed, both in the Tax Court and the Court of Appeals.<sup>209</sup> The case involved a theater group that, in a state of financial exigency and in furtherance of its exempt purposes, syndicated a play. Despite the existence of private investors, the courts involved agreed that the theater society should not lose its tax exemption solely because it structured the financing of the play as a limited partnership.

These two court opinions and the case settled in 1980<sup>210</sup> forced the IRS to substantially modify its position on the subject as noted by the rulings issued since 1980.<sup>211</sup>

### III. RECENT TAX DEVELOPMENTS INVOLVING NONPROFIT HOSPITALS

Current developments in the field of federal tax law pertaining to nonprofit hospitals generally encompass four categories: (1) basic exemption requirements; (2) the carrying on of a trade or business unrelated to the hospital's exempt purpose; (3) the participation in joint ventures or partnerships with profit-motivated investors; and (4) the restructuring of what traditionally was a single institution (a hospital) into several affiliated organizations, each with its own purpose, constituting a "hospital system."

#### A. Basic Exemption Requirements

In recent months, there has been little activity on the federal tax front pertaining to tax exemptions for charitable hospitals.<sup>212</sup> The general theme which continues to permeate all federal tax law pertaining to hospitals is that an organization can be "charitable" by virtue of its promotion of health.<sup>213</sup>

Despite this rather specific basis for tax exemption, an overriding principle also applies, which is that a charitable organization must serve the public interest.<sup>214</sup> In the health care context, this standard is satisfied where the class of beneficiaries served is sufficiently large, so that the community as a whole benefits.

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209. See *Plumstead Theatre Soc'y*, 675 F.2d at 244-45.

210. *Strawbridge Square, Inc. v. United States*, No. 471-79T (Ct. Cl.).

211. See *supra* notes 199-200 and accompanying text.

212. But see *supra* note 2.

213. See *supra* notes 11 & 16 and accompanying text.

214. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).



As a general rule, a charitable hospital satisfies the requirement of serving a public interest by operating an emergency room open to all persons regardless of their ability to pay for the services. For some hospitals, however, this is an inappropriate test, where, for example, a state planning agency has determined that the operation of an emergency room is unnecessary because it would be duplicative of emergency services and facilities that are adequately provided by other medical institutions in the community. For these institutions, the IRS, in 1983, promulgated alternative criteria, which include whether the board of directors of the institution is drawn from the community; whether there is an open medical staff policy; whether the hospital treats persons paying their bills with the aid of public programs such as Medicare and Medicaid; and, whether the institution applies any surplus to the improvement of facilities, equipment, patient care, and medical training, education, and research.<sup>215</sup>

In this determination, the IRS observed that "[c]ertain specialized hospitals, such as eye hospitals and cancer centers, offer medical care limited to special conditions unlikely to necessitate emergency care and do not, as a practical matter, maintain emergency rooms"; these institutions may qualify as charitable entities, the IRS indicated, where "there are present similar, significant factors that demonstrate that the hospitals operate exclusively to benefit the community."<sup>216</sup> Since the issuance of this ruling in 1983, the IRS has not publicly ruled on the matter of the tax-exempt status of nonprofit hospitals.

One of the more unique determinations by the IRS as to the tax-exempt status of other health care entities occurred in early 1985 when the Service ruled that an organization, formed within a health care system to promote medical care and training, can participate in a joint venture with a for-profit entity, a component of a medical center, without jeopardizing its tax-exempt status.<sup>217</sup> The health care system determined that its community was in need of a free-standing alcoholism/substance abuse treatment center; the joint venture was developed to blend the expertise of the for-profit corporation and the familiarity of the exempt organization with the community. Finding that the joint venture "will tend to promote the more effective and efficient delivery of health care to the

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215. Rev. Rul. 83-157, 1983-2 C.B. 94.

216. *Id.* at 95.

217. Priv. Ltr. Rul. 8521055.

community being served," the IRS ruled that the charitable organization can participate in the joint venture in furtherance of its charitable purposes.

Hospitals rarely engage in lobbying to the extent that the federal tax rules prohibiting substantial legislative activities<sup>218</sup> are transgressed. There is no known instance of a hospital being denied, or losing, its tax exemption because of lobbying or political campaign involvement.<sup>219</sup>

### B. *Related or Unrelated Trade or Business*

The domain of unrelated trade or business income taxation of hospitals is frequently visited by the IRS. While subject to the general rules of unrelated income taxation,<sup>220</sup> albeit with some statutory exemptions,<sup>221</sup> hospitals present unique and complex issues.

One persistent issue is the tax treatment of revenue derived by a charitable hospital from the performance of diagnostic laboratory testing upon specimens from private patients of the hospital's staff physicians. It is the position of the IRS that this type of revenue is unrelated income — a position derived from the Service's long-standing conclusion that a hospital that sells pharmaceuticals to the general public is engaged in an unrelated business.<sup>222</sup> In both instances, the rationale of the IRS is identical: the specimens are derived from, and the pharmaceuticals are sold to, members of the general public who do not otherwise avail themselves of the hospital's medical and diagnostic facilities.<sup>223</sup> Also, in both instances, the Service concluded that there is no substantial causal relationship between the achievement of the hospital's exempt purposes and the provision of testing for or the sale of pharmaceuticals to the public.

Therefore, it is clear that the IRS continues to differentiate, in determining relatedness, between services by a hospital to its patients and to nonpatients.<sup>224</sup> Indeed, this distinction represents a

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218. See *supra* text accompanying notes 81-87.

219. See *supra* text accompanying notes 88-89.

220. See *supra* text accompanying notes 110-27.

221. See *supra* text accompanying notes 191-93.

222. Rev. Rul. 68-374, 1968-2 C.B. 242. Cf. I.R.S. Technical Advice Memorandum 8314002.

223. Rev. Rul. 85-110, 1985-30 I.R.B. 18.

224. This position is traceable to the I.R.S.' definition of the term "patient," found in Rev. Rul. 68-376, 1968-2 C.B. 246.

contemporary application of the fragmentation rule,<sup>225</sup> in that services to nonpatients are not regarded as losing their identity as businesses merely because the hospital also provides the same services to its patients. Further, although this aspect of the matter is not discussed in the law and analysis portions of a recent ruling,<sup>226</sup> the IRS appears to be positioning for a "competition" test by noting that, in the specimens testing situation, commercial laboratories that perform identical testing are available in the hospital's community.

The IRS has not expressly employed the doctrine of "competition" in assessing whether an activity of a hospital is related or unrelated.<sup>227</sup> However, in this 1985 ruling concerning laboratory services as unrelated activities, the IRS stated, as part of the fact summary, that "[c]ommercial laboratories that perform testing identical to that performed by the hospital are available in the area."<sup>228</sup> While this observation was made to support the rationale for treating some services as related (under the "unique circumstances" standard),<sup>229</sup> it seems clear that the IRS does regard a service as inherently noncharitable (unless provided to affiliates or by a teaching hospital) where there is a commercial counterpart to that service.

Having firmly staked out its position on hospital testing for nonpatients, the IRS has been just as quick to formulate some exceptions. One set of exceptions is embraced by the standard of, as termed by the IRS, "unique circumstances," which can cause laboratory testing to be an exempt function. One application of the "unique circumstances" standard concerns the "emergency laboratory diagnosis of blood samples from nonpatient drug overdose or poisoning victims in order to identify specific toxic agents," which "is a necessary community service the absence of which would hinder or jeopardize the medical care of patients of other health care institutions lacking such diagnostic facilities." The IRS has ruled that a charitable hospital may provide these emergency services in furtherance of its exempt functions where "referral of these specimens to other locations would be detrimental to the health of hos-

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225. See *supra* note 131 and accompanying text.

226. Rev. Rul. 85-110, 1985-30 I.R.B. 18.

227. A matter of growing importance and concern within the tax-exempt organizations community generally is the extent (if any) to which tax-exempt organizations are unfairly competing with for-profit businesses.

228. Rev. Rul. 85-110, 1985-30 I.R.B. 18.

229. See *infra* text accompanying note 230.

pital nonpatients.”<sup>230</sup> Another application of the standard treats testing as an exempt function “if other laboratories are not available within a reasonable distance from the area served by the hospital or are clearly unable or inadequate to conduct tests needed by hospital nonpatients.”<sup>231</sup>

Another exception to this general rule pertains to teaching hospitals. The IRS has acceded to the view that a teaching hospital which conducts nonpatient laboratory testing on specimens needed for the conduct of its teaching activities is not engaged in an unrelated business where the outside testing services contribute importantly and substantially to the hospital’s teaching program.<sup>232</sup> This position, which emanated from a court opinion, represents a reversal of the IRS’ former rejection of the teaching hospital exception.<sup>233</sup>

Aside from the issues of laboratory testing and pharmaceutical sales, there are many instances where services provided by a health care organization were recently deemed to be related activities. These include drug testing by a teaching hospital,<sup>234</sup> sale of the silver by-product of X-ray film,<sup>235</sup> operation of a community health club,<sup>236</sup> provision of CAT scanners to unrelated health care providers,<sup>237</sup> collection services for radiologists,<sup>238</sup> operation of condominium residences for patients,<sup>239</sup> and the rental of pagers to staff physicians.<sup>240</sup>

Certain income-producing activities by hospitals and like entities have been ruled to be non-taxable activities, either because the endeavor was not regularly carried on<sup>241</sup> or because the income was deemed to be from a passive source.<sup>242</sup>

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230. Rev. Rul. 85-110, 1985-30 I.R.B. at 20.

231. *Id.* See also Priv. Ltr. Ruls. 8305115, 8124076, and 8124006; I.R.S. Technical Advice Memorandum 8314002.

232. Rev. Rul. 85-109, 1985-30 I.R.B. 17. See also Priv. Ltr. Rul. 8325007.

233. *St. Luke’s Hosp. of Kansas City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980). Cf. *Carle Found. v. United States*, 611 F.2d 1192 (7th Cir. 1979), *cert. denied*, 449 U.S. 824 (1980).

234. Priv. Ltr. Rul. 8503047.

235. Priv. Ltr. Ruls. 8511006 and 8452012.

236. Priv. Ltr. Rul. 8505002.

237. Priv. Ltr. Ruls. 8411093 and 8338068.

238. Priv. Ltr. Rul. 8404076.

239. Priv. Ltr. Rul. 8427105.

240. Priv. Ltr. Rul. 8452011.

241. Priv. Ltr. Ruls. 8508099 (amplifying 8428098), 8518039, 8522041, 8522042, 8426100, and 8337075.

242. Priv. Ltr. Ruls. 8511068, 8522040, 8539089, 8408058, 8408057, 8407099, and 8428098.

Other activities of hospitals that have recently been classified as unrelated activities include general testing services,<sup>243</sup> and the provision of services to an affiliated for-profit entity.<sup>244</sup>

The spate of hospital reorganizations in recent years<sup>245</sup> has raised a variety of tax issues, including the tax treatment of various activities as related or unrelated businesses.<sup>246</sup> Simply stated, the contemporary hospital reorganization supplants what once was a single institution (a hospital) with a multi-institution system, comprised of several charitable corporations and one or more for-profit corporations. The unrelated income tax issues arise because within the system there is usually a charitable corporation the purpose of which is to provide management and similar services to the other component organizations in the system.

As discussed,<sup>247</sup> an activity engaged in by a hospital will be deemed a related one where the hospital can substantiate that the activity serves to improve the well-being of its patients, increase the operating efficiency of the hospital, or both.

Generally, the provision of management services by a tax-exempt organization to other exempt organizations is not considered a related activity of the provider organization.<sup>248</sup> However, in recognition of the realities of hospital reorganizations, in that the multi-institution system is in actuality one large health care provider, the IRS treats the provision of management services within the system as related activities.

The IRS has privately ruled on several occasions that the sharing of management services among affiliated tax-exempt health care organizations does not result in unrelated business activity. In one instance,<sup>249</sup> for example, a charitable hospital explicitly stated to the IRS that it would provide a multitude of services to its parent supporting organization and its exempt affiliates. These services were stated to include long-range planning, fund-raising, budget reviews, computer services and equipment, office space, security and property maintenance services, utilities, personnel services, clinical services, accounting and legal services. The IRS

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243. Priv. Ltr. Rul. 8417002.

244. Priv. Ltr. Ruls. 8523069 and 8520008.

245. See *infra* notes 290-95 and accompanying text.

246. See *supra* notes 110-27 and accompanying text. Another frequently raised issue is the "public charity" status of organizations. See *supra* notes 90-109 and accompanying text.

247. See *supra* notes 110-27 and accompanying text.

248. Rev. Rul. 72-369, 1972-2 C.B. 245.

249. Priv. Ltr. Rul. 8439082.

found that the activities of the parent and its tax-exempt subsidiaries would be "substantially related" to the hospital's exempt purposes, because they would contribute importantly to the promotion of health. Consistent with this finding, the IRS ruled that the sharing of facilities and services among these affiliated entities would not result in unrelated trade or business and, therefore, not generate unrelated business income.<sup>250</sup>

There are fewer instances of private letter ruling guidelines relating to the situation where a tax-exempt organization in a health care system provides services to an affiliated for-profit organization. In one situation,<sup>251</sup> a publicly supported charitable organization was organized and operated to provide health care services, by serving as the parent corporation for several exempt subsidiaries formed to facilitate health care and for a for-profit subsidiary. The parent stipulated that, to the extent that services would be provided to the for-profit subsidiary by any of the related exempt organizations, the income received would be treated by the recipient as unrelated business income. The IRS did not comment on this point in the ruling letter. Likewise, in another situation,<sup>252</sup> an exempt organization was stated to be treating as unrelated business income amounts received from a taxable subsidiary in exchange for providing management services.<sup>253</sup>

In a 1969 revenue ruling, the IRS discussed the tax consequences to a tax-exempt hospital of the sale of laundry services to other nonaffiliated hospitals.<sup>254</sup> The IRS held that the sale of laundry services to other exempt hospitals is not an activity substantially related to the performance of the selling hospital's exempt purposes. Therefore, the activity was ruled to be an unrelated trade or business and any profits derived would be subject to the unrelated income tax. The IRS also held that the exempt status of the provider hospital would not be affected by these activities, unless the provision of laundry services became a primary function.<sup>255</sup> In this ruling, the IRS further stated that, if the exempt hospital provided

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250. See also Priv. Ltr. Ruls. 8601103, 8552089, 8532042, 8523069, 8520008, 8504131, and 8439082.

251. Priv. Ltr. Rul. 8520008.

252. Priv. Ltr. Rul. 8523069.

253. In Private Letter Ruling 8523049 the IRS ruled that the tax-exempt status of a parent will not be jeopardized because it provides services to its for-profit subsidiary.

254. Rev. Rul. 69-633, 1969-2 C.B. 121.

255. An organization that provides laundry services to exempt hospitals cannot itself qualify under I.R.C. § 501(c)(3). *HCSC-Laundry v. United States*, 450 U.S. 1 (1981). Cf. I.R.C. § 501(e).

services to a proprietary hospital above cost, the activity would have no effect upon its exemption, although, if it provided laundry services at less than cost, its exempt status might be adversely affected because such services would not be in furtherance of an exempt purpose.

Although this 1969 ruling applies factually only to laundry services, the Service presumably would follow it with respect to any sale of services by an exempt organization that it found to not contribute importantly to its exempt purpose. For example, as noted,<sup>256</sup> the IRS has consistently concluded that the provision of managerial and consulting services to unrelated tax-exempt organizations is not itself an exempt function. The provision of administrative and managerial services does not contribute importantly to the exempt purpose of an exempt scientific organization and, therefore, constitutes an unrelated business.<sup>257</sup> This is also true where such services are provided by one exempt scientific organization to another exempt scientific organization.<sup>258</sup> However, the provision of psychiatric services by a hospital to patients of other hospitals was ruled to be related to the hospital's exempt purpose of treating patients.<sup>259</sup>

In a recent private letter ruling, the IRS ruled that an organization's operation of medically supervised health clubs was substantially related to the organization's exempt purposes and, thus, did not constitute an unrelated trade or business.<sup>260</sup> The Service considered, but then rejected, the organization's claim that its exempt purpose was the promotion of health. Instead, the Service found that the charitable purpose of the organization was the provision "of recreational facilities which advance the well-being and happiness of the community in general."

The Service then stated that, regardless of the charitable purpose of the organization, the activities could contribute substantially to the achievement of the exempt purpose only if the services were available to the general community.<sup>261</sup> In determining the

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256. See Rev. Rul. 72-369, 1972-2 C.B. 245.

257. Priv. Ltr. Rul. 8032039.

258. *Id.*

259. Priv. Ltr. Rul. 7927003.

260. Priv. Ltr. Rul. 8505002. *But see* Rev. Rul. 79-360, 1979-2 C.B. 236.

261. The rationale behind this requirement is that the exempt purpose must be to serve the public at large rather than a small group. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). "The fact that fees are charged, even commercially comparable fees, does not detract from the 'relatedness' of the activity unless the existence and magnitude of the fees charged preclude the general community from benefiting from the activity." Priv. Ltr. Rul. 8505002.

availability of the services to the general community, the Service relied upon data provided by the organization which showed that: (1) its rates were affordable to most segments of the community served by the organization; and (2) its members were broadly representative of the community and were drawn from all economic groups.<sup>262</sup>

Some hospitals have placed what would otherwise be substantial unrelated business activities into one or more for-profit subsidiaries. In one instance,<sup>263</sup> a charitable organization organized and operated to provide health care services was the parent of a for-profit subsidiary formed to provide purchasing, management, and financial services to unaffiliated hospitals. The IRS ruled that the activities of the for-profit subsidiary, the ownership of the capital stock of the subsidiary by the charitable organization, and the receipt of dividends on the stock by the charitable organization would not affect the exempt status of the charitable organization or give rise to unrelated business taxable income.<sup>264</sup>

The IRS generally has not addressed the question of whether the size of the for-profit subsidiary's unrelated business activities, relative to the exempt parent's charitable program, can eventually jeopardize the exempt status of the parent. Recently, however, some formalities that should be complied with in order to ensure that the activities of the for-profit subsidiary will not be imputed to the exempt parent have been suggested. The Chief Counsel of the IRS has held that the holding by a parent organization of the stock of a taxable subsidiary corporation should not affect tax-exempt status where the subsidiary is formed for a bona fide business purpose, the subsidiary is not a mere instrumentality of the parent organization, and the parent does not participate actively in the day-to-day management of the subsidiary.<sup>265</sup>

As discussed, one of the statutory exceptions to the general definition of an unrelated business is the activity that is performed primarily for the convenience of the tax-exempt organization's members.<sup>266</sup> One court held that physicians on the staff of a teaching hospital are "members" of the hospital for the purpose of the

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262. In so doing, the Service distinguished this set of facts from those in Rev. Rul. 79-360, 1979-2 C.B. 236.

263. Priv. Ltr. Rul. 8520008.

264. See also Priv. Ltr. Rul. 8504131.

265. G.C.M. 39326 (Aug. 31, 1984).

266. See *supra* note 161 and accompanying text.



exception.<sup>267</sup> However, the IRS has refused to accept that interpretation, ruling that staff physicians acting in their capacity as private practitioners are not "members" (nor "employees") of the hospital.<sup>268</sup>

Another previously discussed statutory exception to the general definition of an unrelated business is made for the provision of services by an exempt hospital to certain other small hospitals.<sup>269</sup> One of the requirements to qualify for this exception is that the service must be provided at a fee not in excess of actual cost, including straight-line depreciation and a reasonable rate of return on the capital goods used to provide the services.<sup>270</sup> Under recently issued Treasury Regulations, determinations as to the cost of services and the applicable rate of return are to be made as prescribed in the Medicare rules.<sup>271</sup> These rules<sup>272</sup> are a "safe harbor" for use in complying with the limitations on fees. Under these rules, a rate of return on capital goods will be considered reasonable as long as it does not exceed, on an annual basis, a percentage which is based on the average of the interest rates on special issues of public debt obligations issued to the Federal Hospital Insurance Trust Fund for each of the months included in the hospital's tax year during which the capital goods are used in providing the services. For years beginning on or before May 14, 1986, the rate of return is 1.5 times the average of the interest rates on the above-described public debt obligations which were in effect on or before April 20, 1983.<sup>273</sup>

As discussed, one-time sales, as opposed to an ongoing income-producing program, are not activities which are regularly carried on.<sup>274</sup> For example, a tax-exempt diagnostic and health care organization developed computer software to assist in its patient admissions, billings, payroll, purchases, and medical records. The sale of some or all of these programs to an exempt organization composed of a university's three teaching hospitals was held to be a "one-

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267. *St. Luke's Hosp. of Kansas City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980).

268. Rev. Rul. 85-109, 1985-30 I.R.B. 17.

269. I.R.C. § 513(e). See *supra* notes 163-64 and accompanying text.

270. I.R.C. § 513(e)(3).

271. Treas. Reg. § 1.513-6(a)(3).

272. 42 U.S.C. § 1395x(v)(1)(A) and (B).

273. Treas. Reg. § 1.513-6(a)(3).

274. Treas. Reg. § 1.513-1(c)(2)(iii). Cf. Priv. Ltr. Rul. 8349006.

time-only operation" and, thus, did not create unrelated business income.<sup>275</sup>

### C. Joint Ventures

Any relationship between nonprofit hospitals and physicians has, for decades, engendered great suspicions at the IRS. Indeed, the original hostility of the IRS to involvement by charitable organizations in partnerships is traceable to partnerships involving nonprofit hospitals and physicians organized for the purpose of constructing and operating medical office buildings.<sup>276</sup>

In recent years, many nonprofit hospitals have participated as general partners in partnerships, with profit-motivated investors as limited partners. These limited partnerships are usually entered into by hospitals, which either lack the funds or do not wish to commit the funds, to acquire and/or develop real property or to acquire medical equipment. By entering into partnerships, hospitals can acquire the funding necessary to carry out their health care promotion programs without giving up the principal incidents of outright ownership, such as control, management, and cash flow, and the impression that the property is owned by the hospital. In addition, hospitals often have the option to purchase the property from the partnership after a period of time.

Two problems can arise for a hospital involved as a (or the) general partner in a partnership. First, and most importantly, if the purpose of the partnership is not in furtherance of health care delivery or if substantial benefits are provided to the for-profit partners, the participation in the partnership will endanger the hospital's tax-exempt status.<sup>277</sup> Second, participation by a hospital as managing general partner in a partnership which acquires and leases property may, as has been discussed,<sup>278</sup> give rise to unrelated business taxable income.

Hospitals have been as active as any type of tax-exempt organization in participation in partnerships. Thus, for example, of the approximately thirty private letter rulings issued by the IRS through 1985 concerning exempt organizations in partnerships, twelve involve hospitals functioning as general partners in these

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275. Priv. Ltr. Ruls. 8438044 and 8426100. See also Priv. Ltr. Rul. 7905129.

276. See, e.g., Bromberg, *Federal Income Tax Consequences of Medical Office Buildings*, 36 JOURNAL OF THE HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION (No. 11) 13 (1982).

277. See *supra* text accompanying notes 199-201.

278. See *supra* text accompanying note 140.

arrangements. Of these rulings, eleven concern partnerships to acquire and develop a medical office building,<sup>279</sup> four concern the development of health care service facilities,<sup>280</sup> and two pertain to the acquisition of a CAT scanner.<sup>281</sup>

In these instances, the Service has generally followed the analytical approach discussed above.<sup>282</sup> That is, to determine that the partnership's activities were not in conflict with the general partner's exempt purposes, the Service applied the tests used to determine whether an activity is substantially related to the exempt purposes. Thus, the development of a medical office building adjacent to a hospital was found sufficiently in furtherance of the hospital's exempt purpose because the staff physicians are encouraged to use the hospital facilities to their full capacity, thereby promoting health, and because the physicians are accessible if an emergency should require their presence at the hospital.

As discussed,<sup>283</sup> the IRS will tolerate the participation as a general partner in a partnership by a hospital or other charitable organization as long as the partnership itself is in furtherance of a charitable purpose. By contrast, where the partnership purpose cannot satisfy the charitability standard, the exempt organization/general partner will be deprived of its tax-exempt status. If that threshold standard is met, the IRS looks to determine whether the exempt organization is adequately insulated from the day-to-day responsibilities as general partner and whether or not the limited partners are receiving an "undue" economic benefit.

To date, the IRS has not issued a private letter ruling to a hospital or to any other type of tax-exempt organization revoking its tax-exempt status because it is functioning as a general partner in a partnership. That is, in all instances to date, the IRS has concluded that partnerships involving hospitals are in furtherance of charitable purposes. Nonetheless, hospitals and other charitable entities must proceed cautiously when becoming involved in partnerships and other joint ventures, always being careful to be able to rationalize their involvement as being in furtherance of a charitable purpose.

It is somewhat anomalous that the IRS has struck this posture

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279. Priv. Ltr. Ruls. 8551051, 8542070, 8534101, 8528080, 8506102, 8323133, 8217022, 8226147, 8312129, 8201072, and 8325133.

280. Priv. Ltr. Ruls. 8534096, 8534089, 8531069, and 8504060.

281. Priv. Ltr. Ruls. 8344099 and 8206093.

282. G.C.M. 39005 (June 28, 1983).

283. See *supra* notes 199-201 and accompanying text.

on the subject of charities in partnerships, in that Congress has twice specifically addressed the field without enacting any prohibitions on exempt organizations as partners in partnerships.

In one instance, Congress has said that, in determining whether the income received by an exempt organization from a partnership is unrelated, the partnership structure is looked through and the ultimate source of the revenue is ascertained and reviewed.<sup>284</sup> The courts have made it clear that this rule applies irrespective of whether the charitable organization is a general or a limited partner.<sup>285</sup> Certainly, this rule would be rather superfluous for hospitals and other charitable institutions if the mere participation as a general partner in a partnership would cost them their charitable status. There is nothing in this law, its legislative history, or its interpretation by the courts that would limit charitable organizations to only charitable partnerships.

The other instance is the "tax-exempt entity leasing" rules, enacted in 1984 to stop abusive sale-leaseback practices by tax-exempt organizations.<sup>286</sup> Here the law explicitly recognizes that exempt organizations may be partners in partnerships. Congress wrote very specific rules for situations where exempt entities lease property from partnerships in which they are a partner. While it is outside the scope of this analysis to describe how Congress has endeavored to treat this situation, it may be noted that, in doing so, Congress enacted a law that speaks of a "partnership which has both a tax-exempt entity [including a charitable one] and a person who is not a tax-exempt entity as partners."<sup>287</sup> There is nothing in the exempt entity leasing rules that even remotely suggests that charitable organizations, including hospitals, cannot involve themselves in partnerships with noncharitable entities. Indeed there would have been no point in Congress' resolution of the matter of partnerships having charitable partners if the charitable partners would lose their tax-exempt status by reason of their participation in the partnership.<sup>288</sup>

Consequently, a charitable hospital must be cautious when con-

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284. I.R.C. § 512(c).

285. *Service Bolt & Nut Co. v. Commissioner*, 724 F.2d 519 (6th Cir. 1983), *aff'g*, 78 T.C. 812 (1982).

286. I.R.C. § 168(j).

287. I.R.C. § 168(j)(9)(A).

288. An analysis of the IRS position on this subject appears in Hopkins, *Tax Consequences of a Charity's Participation as a General Partner in a Limited Partnership Venture: A Commentary on the McGovern Analysis*, 30 TAX NOTES (No. 4) 361 (Jan. 27, 1986).

templating a participation as a general partner in a partnership. Its tax exemption may be adversely exposed unless the purpose of the partnership itself is to advance a charitable purpose—even though the IRS has for years recognized that there is no such thing as a “charitable” partnership.<sup>289</sup>

#### D. Hospital Reorganizations

In order to provide for greater efficiency in operation and organization and for expanded services, hospitals are frequently splintering their activities into a variety of related tax-exempt and for-profit organizations.<sup>290</sup> In addition, hospitals may use affiliated entities to conduct unrelated trades or businesses, by “spinning off” these unrelated businesses into wholly-owned for-profit subsidiaries. The consequence is a multi-institution system, consisting of many entities (usually corporations), most of which are tax-exempt, with one or more being for-profit organizations. Of the tax-exempt organizations, most are “charitable” in nature,<sup>291</sup> while some may be classified as “social welfare” organizations<sup>292</sup> or title-holding corporations.<sup>293</sup> Because most of the entities in the system are tax-exempt, the traditional basis for control has been the interlocking directorate, although a growing practice is to use stock as the mechanism for ownership.<sup>294</sup>

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289. Internal Revenue Service Manual 7751 (Exempt Organizations Handbook) § 321.1. Some tax-exempt organizations have begun using pooled income funds (the form of planned giving vehicle authorized under I.R.C. § 642(c)(5)), rather than partnerships, as a means to acquire and maintain property. In this manner, the income beneficiaries become entitled to the tax preferences generated by ownership of property (principally, the depreciation deduction). Priv. Ltr. Ruls. 8552021, 8539051, 8535048 and 8347010. However, proposed and temporary regulations, T.D. 8033, 1985-31 I.R.B. 6, would, where the property owned by the pooled income fund is located on the site of the charitable organization that is the remainder interest beneficiary of the fund, treat the organization's right of access to the fund's property as a “lease.” Such treatment would cause the lease to be a “disqualified lease” under the tax-exempt entity leasing rules, I.R.C. § 168(j), and would force the property to be depreciated over a forty-year, rather than the preferable nineteen-year, recovery period.

290. See, e.g., Priv. Ltr. Ruls. 8523069 and 8519052.

291. That is, they are described in I.R.C. § 501(c)(3). The primary test to determine whether such entities qualify for tax-exempt status under section 501(c)(3) is whether the activity of the newly created entity is performed as an integral part of the hospital and is an activity that could be performed by the hospital directly for its own benefit. Rev. Rul. 78-41, 1978-1 C.B. 148; Priv. Ltr. Rul. 8517066.

292. I.R.C. § 501(c)(4).

293. I.R.C. § 501(c)(2).

294. For many, the concept of a stock-based nonprofit organization is inconsistent with the federal tax law requirements, such as the “private inurement” proscriptions. See *supra* text accompanying notes 56-61. However, the few states that allow nonprofit corpora-

The typical reorganization often results in a hospital foundation or other form of "holding company" serving as the "parent" organization. The parent generally is classified as a public charity under I.R.C. § 509(a)(3) by virtue of its being a supporting organization for its beneficiary subsidiary hospitals and other charitable institutions within the system.<sup>295</sup>

The relationship between a parent in a hospital system and the subsidiary hospitals and other charitable entities is the reverse of the usual relationship between supported and supporting organizations, in that the benefits flow down. Thus, a common structure is an arrangement in which the charitable hospital and its supporting or other affiliates are in turn the subsidiaries of the section 509(a)(3) "foundation." Indeed, in the over 350 hospital reorganization private rulings issued by the IRS in recent months, nearly 200 of them involve the use of section 509(a)(3) entities.

Typically, either the parent organization or one of its exempt affiliates engages in fund-raising activities. There are numerous advantages in separating the fund-raising activities from the day-to-day hospital activities, primarily with respect to reimbursement. Medicare requires that certain hospital costs be reduced by revenues generated from non-patient care activities. By separating non-patient care revenues, such as charitable contributions, from hospital transactions, offsets may be limited. Furthermore, establishment of the fund-raising entity results in separating fund-raising costs from hospital operating costs.

The activities of a fund-raising entity need not be limited solely to the giving of grants to the beneficiary organization. The entity may be utilized for the sale or lease of health care services, equipment or facilities. Income derived from these activities, if carried on directly by the hospital, could reduce its Medicare reimbursement, while this might be avoided by the use of a fund-raising entity. Each of these additional activities, instead of being conducted by the fund-raising entity, also may be conducted by another individual entity. The proliferation of entities affiliated with hospitals is designed to result in greater efficiency of operations with respect to the activity conducted by each entity.

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tions to issue stock, e.g., Delaware, require that the stock not pay dividends. Thus, the exempt organizations that are stock-based are formed in a state that allows such corporations. If the hospital system of which these corporations are components is located in another state, these "foreign" corporations are qualified (by issuance of a "certificate of authority") to conduct their functions in the system's state.

295. See *supra* text accompanying notes 106-09.

As discussed, there are no clear guidelines with respect to the question of the amount of unrelated business activity in which a hospital may engage without risking the loss of its exempt status. One way to circumvent this uncertainty has been for the hospital, and other types of public charities planning to engage in substantial amounts of unrelated business activity, to "drop" this activity into one or more wholly-owned for-profit subsidiaries.<sup>296</sup>

In a series of private letter rulings the IRS has consistently and repeatedly recognized the charitable status of organizations conducting unrelated business through for-profit subsidiaries. These private letter rulings reflect these three fundamental precepts: (1) the Service views the creation of the for-profit subsidiary as an investment by the charity not prohibited by the federal tax law;<sup>297</sup> (2) the receipt of dividends from the for-profit subsidiary is a return on the investment by the parent and will not jeopardize its tax-exempt status;<sup>298</sup> and (3) the tax-exempt status of the parent will not be jeopardized if the parent and subsidiary share management and office space (but not financial accounts), nor will the gross income of the subsidiary be construed to the parent under these circumstances.<sup>299</sup>

The IRS was moving toward a stricter scrutiny of the elements of the parent-subsidiary relationship, but has been restrained by its Office of Chief Counsel. In considering whether the activities of the taxable subsidiary of an exempt parent could provide a basis for the loss of the parent's exemption, the IRS' lawyers advised that the exempt status of the parent would not be jeopardized where the subsidiary was formed for a bona fide business purpose, was not a mere instrumentality of the parent, and the parent did not actively participate. The factors looked at in this regard included the existence of a bona fide business purpose of the subsidiary, the degree to which the subsidiary is managed by outside, independent directors, the day-to-day involvement, by the parent, in the affairs of the subsidiary, and the nature of transactions between the parent and the subsidiary.

The factors which were found insufficient to warrant attribution of the for-profit subsidiary's activities to the exempt parent include (1) the appointment by the parent of the governing board of the subsidiary, (2) the appointment by the subsidiary's board of

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296. See *supra* text accompanying notes 110-27.

297. Priv. Ltr. Rul. 8308019.

298. Priv. Ltr. Ruls. 8111030 and 8116121.

299. Priv. Ltr. Ruls. 8303019 and 8116121.

the executive officer of the parent, and (3) the ownership, by the parent, of all of the stock of the subsidiary, augmented by the payment of dividends on the stock.<sup>300</sup>

Although there is some present uncertainty as to how the IRS will weigh the presence or absence of the factors noted, the advice of the Chief Counsel provides some planning guidelines for establishing the relationship between the exempt parent and its for-profit subsidiary.

#### IV. CONCLUSION

Clearly, the law of tax-exempt organizations has become complex and more intricacies are in the offing. Today, complexities exist and are evolving in the rules pertaining to obtaining and maintaining tax-exempt status, public-charity/private foundation distinctions, differentiations between related and unrelated activities, and the ownership and utilization of for-profit subsidiaries. Nonprofit hospitals are caught up in this rush of evolving law. Indeed, in some instances—most notably, in the settings of hospital reorganizations and partnership involvements—charitable hospitals are in the forefront of the change.

New principles will arise that will directly impact charitable hospitals. This will be particularly true in three respects: taxable business activities, ownership of for-profit subsidiaries, and partnership ventures.

The courts are rapidly rewriting and expanding the concept of "unrelated activity," by factoring into the definition elements such as "profit motive" and "competition."<sup>301</sup> The Treasury Department and the IRS will be adding to the law in this area by introducing new regulations and new public and private rulings. Congress, spurred by cries from the small business community over allegations of "unfair competition" by nonprofit organizations, may well seek to tighten the statutory rules. All of these developments will directly affect the nonprofit hospital community.

There is little guidance, although cases such as the recent Utah Supreme Court decision<sup>302</sup> may function as the harbinger of developments at the federal level, as to the question of "how much is

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300. See G.C.M. 39326 (Aug. 31, 1984).

301. See, e.g., *Steamship Trade Ass'n of Baltimore v. Commissioner*, 757 F.2d 1494 (4th Cir. 1985); *Carolinas Farm & Power Equip. Dealers Ass'n v. United States*, 699 F.2d 167 (4th Cir. 1983).

302. *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 (Utah 1985).



too much" when it comes to activities other than traditional health care services. Hospitals, or their supporting management foundations, may risk jeopardizing their tax-exempt status, not because, for example, the nature of the relationship between the exempt entity and its for-profit subsidiary justifies attribution of the activities of the one to the other, but rather, because the exempt parent has spawned too many noncharitable, including for-profit, subsidiaries. This uncertainty suggests that hospital planners should consider the number as well as the nature of for-profit subsidiaries.<sup>303</sup>

There is, nevertheless, no cause for alarm. The general precept that the "promotion of health" constitutes a charitable purpose continues fully in force, thereby affording tax-exempt status to a wide range of entities. The courts, federal and state, continue to recognize new forms of charitable health care providers, in the face of IRS protestations.<sup>304</sup> Nonprofit hospitals, and their affiliates and subordinates, continue to fare very well under the rules classifying charitable organizations as entities other than private foundations. Even in the field of unrelated income taxation, hospitals are experiencing much success, as business endeavors are being found to be related activities because the functions promote community health or enhance the programs of teaching hospitals. Along with the generally positive developments on the exempt organization side of the charitable ledger, nonprofit hospitals continue to do well in attracting charitable (deductible) contributions.<sup>305</sup>

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303. Under existing law, the number of for-profit subsidiaries of a tax-exempt parent may not be a material factor where all of the income flowing from the subsidiaries to the parent is in the form of (non-taxable) dividends. See *supra* text accompanying notes 136-37. However, a provision of the proposed Tax Reform Act of 1985 that passed the United States House of Representatives on December 17, 1985, H.R. 3838, 99th Cong., 1st Sess. (1985), contains a provision (H.R. 3838 § 311) that would create for corporations a "dividend paid exclusion" for dividends paid out of certain corporate earnings that have been subject to tax. A special rule, applicable where a tax-exempt organization owns at least five percent of a for-profit corporation's stock, would treat the deductible portion of dividends paid to the tax-exempt shareholder as taxable unrelated business income. This rule, if enacted, would pose difficulties for a hospital or other tax-exempt organization that has created several for-profit subsidiaries and is receiving sizeable amounts of dividend income. See H. REP. 99-426, 99th Cong., 1st Sess. (1985) at 234-42.

304. *Sound Health Ass'n v. Commissioner*, 71 T.C. 158 (1978); *Virginia Professional Standards Review Found. v. Blumenthal*, 79-1 U.S.T.C. ¶ 9167 (D.D.C. 1979).

305. According to the American Association of Fund-Raising Counsel, Inc., of the \$74.25 billion in charitable giving in the United States in 1984, \$10.44 billion (or 14 percent of the total) was contributed to hospitals and other health care providers. This contrasts with total giving in 1983 of \$66.82 billion, of which the health care community derived \$9.43 billion. AMERICAN ASSOC. OF FUND-RAISING COUNSEL, INC., *GIVING USA ANNUAL REPORT 6* (1985).

The federal tax law affecting tax-exempt organizations is changing, with new definitions, unexpected directions, and overwhelming expansion. The nation's nonprofit hospitals must recognize, use and seek to influence these changes in the interest of the public which they serve.

